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NEW APPROACHES TO THE THIRD WORLD DEBT PROBLEM

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

TO

DEVELOP A BETTER UNDERSTANDING OF THE COMPLEX DEBT PROBLEM IN AN EFFORT TO MOVE TOWARD A CONSTRUCTIVE, WORKABLE, AND TIMELY SOLUTION

FEBRUARY 8 AND MARCH 16, 1989

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NEW APPROACHES TO THE THIRD WORLD DEBT PROBLEM

WEDNESDAY, FEBRUARY 8, 1989

U.S. Senate, Committee on Banking, Housing and Urban Affairs, Subcommittee on International Finance and Monetary Policy,
Washington, DC.

The subcommittee met at 9:30 a.m. in room SD-538, Dirksen Senate Office Building, Senator Paul S. Sarbanes (chairman of the subcommittee) presiding.

Present: Senators Sarbanes, Shelby, Mack, Graham, Bond, Sanford, Wirth, Gramm, and Heinz.

OPENING STATEMENT OF SENATOR SARBANES

Senator **Sarbanes**. The subcommittee will come to order.

Today the Subcommittee on International Finance and Monetary Policy will begin a review of the growing number of new approaches to the Third World debt problem which have been published in recent months. This is the first Senate hearing on the urgent debt issue to be held in this Congress, and it is the first in a series which we plan to hold in the subcommittee on a continuing basis to address this issue. It is our objective to develop a better understanding of the complex debt problem in an effort to move toward a constructive workable and timely solution. Later this month the Banking Committee will receive a report from the Secretary of the Treasury, which was mandated by last year's Omnibus Trade and Competitiveness Act, examining the Third World debt issue, particularly with respect to the possibilities of an international debt management authority.

The trade bill also directs the Federal banking regulatory agencies to report on the extent of any regulatory obstacles to negotiated reductions in the debt service obligations associated with foreign debt.

Today's hearings will enable our expert witnesses from the private sector to outline their analysis and recommendations with respect to many of the major issues which the Treasury report later this month will be addressing.

It might be said, where the debt issue is concerned, we are living on borrowed time. The crisis first came to public attention nearly 7 years ago. In many important respects the dimensions of the problem are greater today than was the case then and a definitive solution is no nearer at hand. While the 1985 Baker plan marked an important turning point in U.S. policy, in the sense that it acknowledged there could be no sound solution to the debt problem without a resumption of economic growth, since prior to the Baker plan, the prevailing debt strategies required debtor nations, in effect, to shrink their way out of their problems by imposing severe austerity programs. These programs stunted economic growth in the debtor countries without providing any real solution to the debt problem.

Now the Baker plan endorsed the principle of economic growth as a key to addressing the debt burden; however, the plan has not been effective in bringing about a resumption in growth. In fact, renewed lending by the commercial banks, a principal and important element in the Baker plan, has not been forthcoming. In fact, there has been a net outflow of resources from the debtor countries contributing to economic stagnation. Investment has dropped, incomes have fallen, unemployment has risen, inflation has escalated. Per capita GNP in Latin America last year was 6.5 percent lower than in 1980.

For the United States, the painful effects of debt-induced austerity have been obvious for some time. Because debtor nations have had to use scarce foreign exchange for debt service, they have both restricted their imports and expanded their exports, with the results that U.S. export markets, especially in Latin America, have shrunk and U.S. exports have confronted increased competition in Third Country markets, and U.S. companies have encountered increased competition in our domestic market as the debtor countries have sought to expand their exports to the United States.

The ramifications of this problem extend beyond matters of trade in the Western Hemisphere. More than ever, the attractable debt obligations are an impediment to world economic growth. They pose a serious threat to political stability in newly emerging democracies. They have become a source of significant international tension. A way must be found to involve all of the creditor countries, particularly those such as Japan which are running current account surpluses in bringing about a resolution of a problem.

The international debt management authority, which many in the Congress have focused attention on, would be one mechanism to bring about such multilateral cooperation.

Clearly, there is a growing consensus on the urgent need to solve the debt problem by addressing its root causes. In recent months, a number of highly respected groups have issued reports calling for new approaches to the debt problem of the developing world, and it is to representatives of these groups that we will be turning this morning. We have taken John Williamson out of order—we were originally going to include him on the second panel—because he has another engagement, and we hope to hear from him. You need to go by what? 10:15? 10:10, 10:15?

Mr. **Williamson**. If possible, yes.

Senator **Sarbanes**. So we will try to accommodate that.

The Institute for International Economics, a prominent institution devoted to the study and analysis of international economic issues, has issued a number of studies and reports in this area. I will introduce members of the other two panels when we turn to them, and I think we will go and take Mr. Williamson, although I will defer for a moment to see if my colleagues have any statement they wish to make, or perhaps we should hear from him and then make the statements.

Senator **Shelby**. Mr. Chairman, he's got a time schedule. If you want to go ahead and move, it is fine with me, and then we will get back to any comments we have.

Senator **Sarbanes**. Mr. Williamson, we will hear from you, and then we will bring the first panel up. Before the first panel begins, I will accord an opportunity to my colleagues to make any opening statements they have on this very important issue.

If you would go ahead, sir. John Williamson is a senior fellow at the Institute for International Economics. He has held a number of important academic posts at different universities and has published considerably on international monetary issues and on the debt question. In fact, he issued a report back in September himself on voluntary approaches to debt relief, and Fred Bergsten, the head of the Institute, only recently has issued a major statement, including an important chapter on that issue.

So we are prepared to hear from you, sir.

STATEMENT OF JOHN WILLIAMSON, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Mr. **Williamson**. Thank you very much, Mr. Chairman. I am one of those who regard the request of President Bush for a review of the debt problem as extremely timely. I am delighted that this subcommittee is involving itself in that debate, and I am honored to have been invited to contribute. My only regret is that I have this longstanding engagement in New York which is going to compel me to leave early.

SITUATION AT THE PRESENT TIME

If I may, I will start by making one or two general remarks about the debt problem as it is now. I think, in strategic terms, the major factor is that at this stage the banks are in a very much stronger financial position relative to the size of their Third World debts than they were in 1982, but that the progress of the debtor countries has been much more limited. As you yourself indicated in your opening remarks, Mr. Chairman, they are still suffering from a negative transfer which increased again last year to something close to $30 billion—my figures relate to Latin America, although the Baker 15 are in most cases rather similar.

This major outflow of resources is an impediment to the resumption of growth and to the control of inflation, and therefore a threat to political stability. So I take it for granted that a major objective of the review of the debt problem that is in process at the moment should be to achieve a substantial reduction in that negative transfer.

My own figure of what would be a realistic target to aim for would be to reduce the negative transfer from its recent level of $20 billion or $30 billion a year to perhaps $10 billion. I doubt whether it is possible to get it down to zero or to replace it by a net inflow because—unless one does almost everything by debt reduction, in which case one would not see much new lending—the debt would escalate once again, if one did achieve such a reduction by debt postponement. I think a realistic target is to reduce it to something like $10 billion a year.

I would say that the major emphasis should be to reduce it for the countries that have already implemented major policy reforms. I can think of half a dozen countries in that category in Latin America—first of all Mexico, which is back here in town negotiating at the moment. Among the other large countries, one certainly has to include Chile, and I think also Colombia, and then among the smaller countries, I would include Bolivia, Costa Rica, and Uruguay.

The other general remark I would make is to say that at this point, we ought to recognize that what has long been taken as the aim of the debt strategy is no longer realistic in any reasonably short time horizon. That aim has been to return the countries to voluntary access to capital markets. The problem with that objective is that it is likely to require us to wait an awfully long time for the debt crisis to be resolved. So at this stage, we really ought to adopt at least the interim objective of reducing and restructuring the debts of the countries that have done serious policy reforms to a point where their resumed growth is consistent with fulfillment of their contractual obligations, without having to go through the constant hassle of debt renegotiation.

A STRATEGIC CHOICE

If one takes that as the objective, one very quickly comes to a strategic choice as to how one is going to go about it. That strategic choice arises because of the well-known free rider problem, which consists in the fact that although each individual bank may recognize that it is good if all banks make concessions, each individual bank still has an incentive to be the one that stands out and doesn't make the concessions and gets the benefit of the others making concessions. There are two ways of dealing with the free rider problem. One is to try and get all banks to act in the same way, which is what the initial strategy did when all the banks were supposed to reschedule and provide new money pro rata to their outstanding exposure. The alternative is to offer them a menu of options which hopefully have roughly equal value to the debtor country, so that the debtor can get a benefit, no matter which particular option the country chooses. That is how policy was shifted a couple of years ago.

In designing any revised strategy to deal with the debt problem, one will again confront that same strategic issue: should all banks be required, or at least encouraged, to make the same concessions, or should they be offered a range of options? I am strongly in favor of approaching it by making a range of options available. I am sure you will hear the other case presented later this morning, but I see two major advantages in designing a range of options. One is the difficulty of getting all the banks to agree to give the same concessions, given their very different positions and interests. The other is the danger of lengthening even further the estrangement between the debtor countries and the banks, which would result from any type of mandatory solution applying to all banks.

If one accepts the desire to have a range of options, then one quickly comes to the conclusion that it will be necessary to have options in two major categories. There should be options involving both debt reduction and the postponement of debt service payments. That makes sense from the point of view of both the banks and the debtors.

From the point of view of the banks, as I mentioned a moment ago, there are very different interests and different attitudes toward debtor countries on the part of different banks. By creating very different options, one can exploit those differences and make it much easier for all banks to contribute to the process. From the standpoint of the debtor countries, I think it is also more advantageous. Essentially, the banks which choose the debt postponement obligation provide some relief in the cash flow. The danger of that, if you don't have some debt reduction at the same time, is that the debt will once again begin to escalate out of control. But, by having the other group of banks doing debt reduction, one can get relief to the cash flow without having the debt once again start to escalate.

So I believe that a revised strategy should try to combine options from both categories.

DEBT REDUCTION

Let me say a few words about both of the categories. First of all, debt reduction. By that term, people have in mind voluntary debt reduction, in the sense that each bank does have options: it isn't compelled to do a particular action. Debt reduction in this sense is widely endorsed: by most of the banks, by the Treasury, the Institute of International Finance, and so on.

I think there is no question that debt reduction has been a helpful innovation, but I do believe that it needs supplementing to make sure that banks that don't engage in debt reduction take on some more formal obligations involving debt postponement.

Let me try and explain why very briefly. There are three methods of debt reduction that have been used so far, and they are in fact the only three that seem on the horizon.

First of all, debt-equity swaps. Their scale is probably going to be more modest in the future than it was last year, primarily because there is a danger of an inflationary impact when carried to excess.

Second, there is the possibility of buybacks on the secondary market at discounted prices, which I regard as a very helpful option when it can be done. But it does require the debtor country to have some cash in hand. And that, again, implies that relief from this source is bound to be slow. It is bound to be slow, at least, unless one can make some new additional source of finance available to finance buybacks. It has been suggested that it might be possible to create a new buyback facility financed by the surplus countries like Japan, which would specifically be prepared to lend medium-term money to finance buybacks. That could provide a useful acceleration of what is otherwise bound to be a very slow process.

The third type of voluntary debt reduction, and the one that perhaps has the most potential, is debt-debt swaps like the Mexican-Morgan deal of a year ago. So far, those haven't been particularly successful. I think the reason is simple: that one has simply replaced one type of debt, which was largely country risk, by another type of debt, which was also largely country risk. What the banks were looking for was either a quicker way out or else a more secure risk.

So one asks, how could one provide that more secure risk, and there are really three ways:

1. Collateralization, but that again requires cash like buybacks. So that doesn't help very much.
2. Subordination of the new debt to existing debt, which is very difficult because it requires unanimity on the part of the banks.
3. Guarantees provided by some outside agency, for which the World Bank seems to be the logical candidate. That was my own preference for encouraging debt reduction. Up to now, the authorities have strongly opposed guarantees on the argument that this could be a bank bailout. But it seems to me that there is a very fundamental difference between guaranteeing new money at 100 cents on the dollar, which provides the possibility of a long-term exit from a shaky loan at 100 cents on the dollar, which can, therefore, be regarded as a bank bailout, and on the other hand, guaranteeing exit bonds in which there is a large up-front reduction in the value of the loan, and the guarantee is given in return for that reduction in the value of outstanding debt. I think that the past objections to guarantees should not be extended to guarantees to exit bonds.

DEBT POSTPONEMENT

As I have argued, debt postponement is a necessary complement to debt reduction, in order to provide an early easing of the cash flow situation. Up to now this has been done by rescheduling and new money packages, but that is a process which, first of all, has not been providing enough money. Second, it is extremely wearing on creditors and debtors. Third, it doesn't give them the security in the medium term that they are looking for.

So what are the alternatives? First of all, to extend that process by having multiyear new money agreements. Alternatively, one could have some process of interest capitalization whereby some part of the interest payments, perhaps the excess over some estimate of ability to pay, based on actual export revenue, would be capitalized and added to the principal. Then the third sort of approach which would be feasible is a commodity link. For example, Mexican debt could be restructured into bonds which would pay a concessional interest rate as long as the oil price remains low, but then the market interest rate, if the oil price returned to previous levels, and a premium if the oil price went even higher. You would thereby match the ability to pay with the obligation to pay.

Comparing these three alternatives, it seems to me that the problem with the first, multiyear new money agreements, is its inflexibility. If we know that a debtor country was going to recover in 5 or 6 years' time, then that might be fine, but the problem is that, if it doesn't, we come back to the need to renegotiate and sort things out yet again. So it doesn't give longer term security—unless, at least, it were on such generous terms that the banks would be horrified.

One attraction of the alternative of interest capitalization is that it would be relatively easy to deal with free riders. As long as the majority of the banks agreed, then I think the recalcitrant minority could simply be allowed to accrue arrears on the same scale as the interest would have been capitalized, and you then get around the difficulties posed by the sharing clause.

But nevertheless, interest capitalization has been strongly resisted by U.S. banks up to now. There have been three reasons given.

First is that capitalization would make it easy for the debtor to increase the extent of interest postponement unilaterally. I think that doesn't apply if you agree in advance on a formula that is going to govern postponement.

Second, it is argued that it is necessary to keep debtor countries on a short leash in order to keep the incentive to pursue policy reforms. But when you are thinking primarily of countries that have already put in place serious policy reforms, then it is really time to let those countries off the short leash.

Third, for American banks in particular, there are real accounting and regulatory problems with interest capitalization. I suggest that it is time that the treatment of interest capitalization was essentially equalized with that of new money packages, where the bank only gets its interest because it pays itself part of the interest. Surely, that is the same thing de facto as interest capitalization and should be recognized as such by the regulations.

THE ROLE OF THE PUBLIC SECTOR

Let me conclude by saying a few words about the role of the public sector in facilitating this process. I think the major role there has to be that of facilitating debt reduction through an IMF buyback facility or through World Bank guarantees or something in that family. In addition, there is the need for regulatory reform of capitalized interest, as I have just indicated. Then the third aspect of the role of the public sector is its role as a creditor, and it turns out that that has been a major problem with the Baker plan.

My colleague, Bill Cline, in a recent paper showed that although the banks had, to some extent, fallen short of what they had been assigned under the Baker plan, the big problem lay with the public sector. The multilateral development banks had not increased their lending on the scale desired, and even more there had been a big reversal in the flow of resources from the IMF to the debtor countries. So one has to begin thinking of what the public sector should be doing.

As far as the poorest countries, mainly in sub-Saharan Africa, are concerned, there was already a significant initiative last year coming from the Toronto summit which was supposed to amount, essentially, to forgiveness of one-third of the debt. I think that sooner or later we are going to have to extend that initiative as regards the poorest countries, either by greater forgiveness or perhaps by conversion to local currency of a further one-third—or maybe the whole—of the rest of the debt for the poor countries. Those funds could be used to finance mutually agreed projects in education or conservation or whatever was regarded as in the mutual interests of creditor and debtor but required local currency expenditure.

That is a concession which I think could be extended to the middle income countries. However, more important for them in quantitative terms for relieving the cash flow is going to be extending multilateral development bank lending at least up to its Baker plan target of $7 billion a year. That seems to me to be the minimum that we ought to be aiming at at this stage.

Thank you.

[The complete prepared statement of John Williamson follows:]

REVIEWING THE THIRD WORLD DEBT STRATEGY

John Williamson
Senior Fellow
Institute for International Economics

Statement before the Subcommittee on International Finance
and Monetary Policy of the
Banking Committee of the US Senate

February 8, 1989

President Bush's timely request for a review of strategy toward Third World debt has been widely welcomed. I am pleased to have this opportunity of participating in the debate that this request has provoked.

Third World debt now poses much less threat to the international banking system than it did when the debt crisis first broke in 1982. The banks have made good use of the intervening period to strengthen their balance sheets and many have also reduced their exposure. Unfortunately the position of the debtor countries has not shown a comparable improvement. The ratio of interest obligations to export revenue, and more recently of debt to exports, has shown some improvement. But the continuing negative transfer from the debtor countries needed to pay accruing interest obligations with minimal offsetting capital inflows remains a major impediment to the restoration of growth and the mastery of inflation, and hence a continuing threat to political stability.

Thus I assume that a principal objective of the review of the debt strategy will be to reduce the negative transfer to a level

that the debtor countries can live and grow with. It is particularly important that countries that have made a serious effort at policy reform should now be given the opportunity of escaping the financial constraint on profiting from that reform by resuming robust growth. (In Latin America I have in mind Bolivia, Chile, Colombia, Costa Rica, Mexico, and Uruguay as countries that have implemented extensive policy reforms.) I doubt whether it is either feasible or advisable (because of the rapid escalation of debt that would be implied) to seek the total elimination or reversal of the negative transfer, but I would suggest an objective of reducing it from its recent level of $20 billion to $30 billion per year to perhaps $10 billion.

For several years it has been taken for granted that the aim of the debt strategy should be to restore the debtor countries to a position where creditors will voluntarily lend them enough to reduce the negative transfer to a tolerable level. It seems to me that maintaining that objective risks pushing resolution of the debt crisis forward into the next century. We should instead aim to reduce and restructure the debts (at least of those countries that have made a serious effort at policy reform) to a point where they can expect to grow while fulfilling their contractual obligations, and eliminate the constant hassle of debt renegotiation.

A Strategic Choice

Everyone is now familiar with the "free rider problem": the incentive that each individual bank has to avoid making concessions to a troubled debtor even when it recognizes that collective concessions are in the best interests of both creditors and debtors, in the hope that other creditors will make the concessions and it will still reap the benefits. The initial reaction to recognition of this problem was to try and ensure that all banks acted in the same way (notably by participating in involuntary new money packages). More recently the trend has been to offer the banks a "menu" from which they can choose an option suited to their particular circumstances. If all of the options carry a roughly similar benefit to the debtor, the latter will not lose from banks acting differently provided that all of them choose one of the options. The hope is that the availability of an option tailored to its own circumstances will encourage each bank to participate rather than act as a free rider.

The same strategic choice between an attempt to get all banks to make the same concessions and the offer of a range of options will arise in designing a revised debt strategy. I strongly favor offering the banks a range of options. One reason is the sheer difficulty of persuading all banks (headquartered in a dozen or more different countries) to agree to the same terms, given the high probability that any attempt to legislate debt forgiveness would be held unconstitutional by the courts as a violation of the

principle of sanctity of contract. Another reason is the danger of provoking a long-term estrangement between the debtors and the banks.

In particular, I believe that the options from which the banks should be expected to choose should include both debt reduction and debt postponement. There are two reasons for wanting to see options in both categories. One is that the differences between the positions of different banks are sufficiently great to need options in both categories if there is to be any hope that all banks would find it preferable to accept one of the options rather than trying to insist on maintenance of the original contract (i.e. freeriding). The other is that a combination of options from the two categories can enable debtors to improve their short-run cash-flow without the level of debt exploding out of control. The debt reduction provided by one group of banks would do little to relieve cash flow for some time (see below), but it would reduce the level of debt. That would permit interest capitalization (or some alternative form of debt postponement) to alleviate the short-run cash flow without an unacceptable increase in the total level of debt.

Debt Reduction

Voluntary debt reduction (which is the same thing that I called "voluntary debt relief" in my study Voluntary Approaches to Debt Relief published by the Institute for International Economics last year) is now widely endorsed--by the banks, the US Treasury, and the other G-7 authorities, as well as the debtors. Helpful as debt reduction is, however, it will almost certainly need supplementing by some form of formal debt postponement. Let me spell out the limitations of debt reduction.

First, debt-equity swaps. This has so far been the principal mechanism employed, with perhaps $15 billion swapped in 1988. A debt-equity swap typically involves a bank selling debt on the secondary market to a foreign company, which in turn sells the debt to the central bank of the debtor country in return for local currency with which it makes an equity investment in the local economy. This changes the form of the foreign claim on the debtor's economy from debt to equity, which may have some attractions in terms of improved efficiency consequential on foreign management and also generates a time-stream of payments obligations that is more responsive to the state of the domestic economy. But it has only a modest effect in reducing the debtor's net international liabilities--an effect that is dependent on the central bank paying less than 100 cents on the dollar for the debt that it buys back (i.e., splitting the secondary market discount with the foreign investor). Thus $15 billion of swaps may have made a dent of no more than $3 billion in foreign liabilities (some 1 percent of the debt to the banks).

Moreover, in some countries, notably Brazil, the pace of debt-equity swaps was excessive last year. Unless the foreign investor buys a newly privatized asset (a phenomenon that was important in

Chile), the central bank has to increase the monetary base in order to provide the local currency to the foreign investor. (In principle the government might issue local currency debt instead, but this is distinctly unattractive in countries where the real interest rate far exceeds the real interest cost of foreign debt.) Some observers believe that the magnitude of debt-equity swaps played a big role in driving Brazil to the verge of hyperinflation, which explains why the program has now been dramatically scaled back. In the future I would expect debtors (supported by the IMF) to be more cautious and seek to limit the volume of debt-equity swaps to a level that the economy can afford.

Second, buybacks. In March 1988 Bolivia bought back almost half its bank debt (using money specially donated by friendly governments) at a price of 11 cents on the dollar. In September Chile got permission from its bank creditors to use a part of its windfall gains from the high copper price to buy back debt on the secondary market, and proceeded in November to buy back some $300 million at a 44 percent discount. A part of the academic literature argues that buybacks are a mistake from the debtor country's standpoint because they involve the use of money that a country could spend on itself in order to eliminate debts that will not be paid in any event. I regard this analysis as nonsense: debts that are not being fully serviced are an obstacle to full participation in the world economy, a constant source of embarrassment, and a potential disincentive to adjustment. When they can be bought back cheaply because some banks are anxious to exit from the lending process at almost any cost, it is foolish not to exploit the opportunity.

The problem is that buybacks require cash, and--almost by definition--troubled debtors are short of cash. Hence a solution to the debt crisis that relies on buybacks to reduce outstanding debt is liable to take a long time. Buybacks are likely to increase in importance relative to debt-equity swaps, because it is more attractive to the debtor to allow inward foreign investment over the foreign exchanges and then, when it seems desirable, to use the proceeds to buy back a part of its debt on the secondary market. This has two attractions: it allows the debtor to capture 100 percent of the discount rather than share it with the foreign investor, and it gives the debtor a continuing choice as to whether to amortize debt or increase imports (or reserves). Hence, as banks become accustomed to granting waivers to facilitate buybacks and as the need to subsidize inward equity investment wanes, I expect to see debt-equity swaps largely displaced by buybacks. But that will not change the conclusion that both these techniques together could only reduce the debt slowly--unless, at least, some substantial new source of money became available to finance buybacks. One could, for example, establish a special IMF facility for this purpose, financed primarily by major surplus countries like Japan (as suggested by C. Fred Bergsten in testimony before the House Banking Committee on January 4, 1989).

The other way of making more rapid progress might be through debt-debt swaps. The precedents here are the Mexico/Morgan deal, and the exit bonds issued by Argentina in 1987 and Brazil in 1988. Unfortunately none of these precedents is particularly encouraging: banks proved unwilling to swap on terms and/or a scale that would have achieved substantial debt reduction. The reason is straightforward: the quid pro quo the banks seek for substantial debt reduction is more rapid and/or more secure exit from their sovereign risk, whereas what they were offered was largely continued country risk.

The security sought by the banks could be provided in three ways: by collateralization, by subordination, or by guarantees. The disadvantage of collateralization is that, like a buyback, it requires the debtor to use its reserves. Indeed, reserves cannot be expected to buy more debt relief per dollar if used in collateralization than in buybacks (which poses a problem for the Miyazawa Plan, at least in its original form). Subordination of existing debt to exit bonds looks attractive until one learns that the required waiver would require unanimity on the part of the banks, which makes its feasibility extremely doubtful. Hence I conclude that a major role for debt-debt swaps would require the provision of guarantees for exit bonds by some public sector agency; the World Bank seems the natural choice for this role.

The authorities of the G-7 countries have up to now opposed the extension of guarantees. I sympathize with their aversion to guaranteeing "new money" that the banks put in involuntarily, since this could provide a way for the banks in the long run to reduce their exposure without loss at the expense of the public sector (i.e., a "bailout"). However, a (partial) guarantee that bought debt reduction from the banks is a totally different proposition. Such a guarantee would apply only where a bank agreed to a large reduction in its claim, and could not make a doubtful claim whole at public expense. And the return expected from such guarantees would be attractive: a guarantee that allowed a debtor to swap outstanding debts with a 10 percent interest rate for exit bonds at a 50 percent discount would yield a real return of 20 percent, entirely in foreign exchange.

Debt Postponement

Debt reduction (other than debt-for-charity swaps, whose scale is miniscule) is not an efficient way of providing cash-flow relief. Debt-equity swaps do bring some short-run relief, but little or none in the longer run once the time-limit on dividend remittances expires. Buybacks and debt-debt swaps provide little short-run relief, since the debtor has to find the cash for a buyback or to service the new debt involved in a debt-debt swap. To complement such programs and provide an early easing of the debtor's cash-flow position one needs options that postpone the obligation to service debt.

Up to now, postponement of debt service has been accomplished through repeated reschedulings and new money packages. The process

of negotiating and gaining approval of these is time-consuming and wearing on creditors and debtors alike. Its perpetuation is not consistent with the objective of eliminating the hassle of constant debt renegotiation and allowing debtors to return to a situation where they fulfill their contractual obligations. A method of debt postponement that formalizes obligations is badly needed.

One approach would involve adapting the past approach by introducing multiyear new money agreements. Such an agreement would promise the provision of specified sums of "new money" over a number of years, perhaps on a decreasing scale. For example, it could provide for new money equal to 60 percent of interest due in a first year, 50 percent in a second year, and so on, decreasing to zero in the seventh year.

A second approach would involve interest capitalization. This could be designed simply to replicate a multiyear new money agreement, but with an indefinite term it could also secure a more permanent solution. For example, a country's interest obligation could be divided into two parts on the basis of an estimate of ability to pay. One portion, equal to an estimate of ability to pay in some base year plus an agreed proportion of the increment in export value over that in the base year, would be payable in dollars. The balance would be added to principal. As a country's export revenue grew over time, the proportion of interest capitalized should tend to fall. If and when ability to pay exceeded interest due, the excess would be used to amortize principal.

A third approach, involving a commodity link, might be suitable for debtors that rely heavily for export revenue on a particular primary commodity whose price they are unable to control. For example, banks might agree to grant Mexico a concessional interest rate as long as the price of oil remains low, but with a provision for full interest payment as and when the oil price returns to a specified threshold, and a premium if the oil price went higher still.

In my opinion the second or third approaches would be more satisfactory than the first. The problem with a multiyear new money agreement is its inflexibility: it assumes one can be sure that the debtor will be in position to return to normal market access at the end of its multiyear term. If that proves overoptimistic, then one will in due course be faced with the need to negotiate a successor agreement. The only way to minimize this danger would be to capitalize such a large proportion of interest for so many years as to jeopardize the acceptability of the proposal to the banks.

An attraction of the second approach is that it would be relatively easy to deal with free riders. Provided that a two-thirds majority of the bank syndicate agreed to restructure the remainder of the debt (i.e. that not dealt with by debt reduction) to capitalize interest above the agreed formula, individual banks

that declined to sign could be paid interest prorata with those that had agreed to capitalize. They would then accumulate the excess as arrears, which would have the same effect as though they too had agreed to capitalize. Since they would be receiving interest on the same basis as the other banks, they would have no basis to sue them under the sharing clause.

Interest capitalization has up to now been strongly resisted by US banks. This was partly explained by a fear that once interest capitalization was instituted it would become too easy for a debtor to announce a unilateral increase in the proportion of interest to be capitalized. Such a fear would not seem very relevant in the context of an agreement that specified ex ante a formula to determine the extent of capitalization. Banks may also have been reluctant to let debtors off the "short leash" provided by the need for negotiations over new money. This may still be a relevant consideration where debtors that have not yet instituted adequate policy reforms are concerned, but it is surely time to let the countries that have made serious reforms off the "short leash". One suspects, however, that the major reason that US banks have always been so much more hostile to interest capitalization than many foreign banks is that the accounting and regulatory treatment of interest deferred though capitalization is so much more harsh. It is surely time to equalize the treatment of interest that is received by virtue of a bank's participation in a new money package and interest that is deferred by capitalization.

The Role of the Public Sector

The major role of the public sector in the proposals developed above is to facilitate the process of debt reduction, either by creating a special facility to finance buybacks at the IMF or by arranging for the World Bank to guarantee exit bonds (or both). In addition, the US authorities should equalize the treatment of capitalized interest with that which a bank pays itself when it participates in a new money operation. But there is a third role of the public sector that is particularly unsatisfactory at the present time: its role as creditor.

My colleague William Cline has recently drawn attention to the depressing and little known fact that the principal reason that the negative transfer has proved much larger than called for by the Baker initiative is that the public sector has fallen seriously short of providing an additional $3 billion per year net lending. A part of the problem is that the multilateral development banks increased their lending by only $300 million rather than $3 billion per year. The other part of the problem is that the Baker initiative did not make allowance for the large turnaround in IMF lending, from an inflow of $6.5 billion in 1983 to a repayment of $1.1 billion in 1988. (See William R. Cline, "The Baker Plan: Progress, Shortcomings, and Future Evolution", paper presented to a World Bank conference on January 16, 1989.) I also heard the Finance Minister of one of the debtor countries recently complain that his most intransigent creditors were not the commercial banks, but the Paris Club.

In fact, the Toronto summit already agreed to an important initiative so far as the poorest countries, primarily in sub-Saharan Africa, are concerned. Each of the participating countries agreed to choose one of three options for restructuring its outstanding official lending to those least developed countries. The simplest option is to forgive one-third of the debt; the other two options are supposed to be broadly equivalent. This initiative is welcome but still inadequate. Ideally one might wish to see the simple solution of greater forgiveness. Failing that, it might be worth considering conversion of a further one-third of the official debt into local currency terms. This debt could bear interest at the rate of local inflation plus 3 percent (say), with the expectation that at least the real interest component would be spent on causes like conservation and education that require local-currency finance and are (hopefully) of mutual interest to creditors and debtors. In conjunction with the Toronto initiative, this would cut the debt service burden of the least developed countries by two-thirds, but with one-half of the relief taking a form that would enable the creditors to support initiatives that they regard as important but that many debtors have had to cut back on during the years of austerity.

It would seem appropriate to consider some relief on bilateral (Paris Club) debts for the middle-income debtors as well as the poorest countries. This might take the form of conversion of a third of the debt to local-currency terms, just like the additional relief for low-income debtors suggested above. In terms of cash flow, however, the major impact will have to come from larger new lending. The minimal aim should be to achieve the Baker target of $7 billion net disbursements by the multilateral development banks.

Summary

The debt crisis has now lasted for 6 1/2 years. In that period a number of the debtor countries have pursued major reforms of the sort that have been urged on them by Washington, but a country like Mexico still cannot look forward to being able to resume robust growth without the need for further debt renegotiation or the danger of financial constraints. Whatever else the current review of the debt strategy may bring, it should ensure that countries that have made serious reforms and continue to pursue prudent policies should have their obligations restructured to match their ability to pay consistent with continued growth. It seems to me that the most promising strategy to that end would present the banks with a choice between debt reduction--aided by an IMF facility to finance buybacks and/or World Bank guarantees of exit bonds--and debt postponement, in the form of interest capitalization and/or a link between interest obligations and the price of major primary commodity exports. The public sector should support that strategy both by authorizing the IMF and/or the World Bank to facilitate debt reduction and by

reducing its own foreign exchange claims on troubled debtors, as well as increasing the flow of lending by the multilateral development banks.

Senator SARBANES. Thank you very much, Mr. Williamson.

In deference to your time problems, and I promised to get you out by 10:15, I will forego any questions. We are very pleased to have your full statement which will be included in the record. I have had a chance to look through it, and it is a very thoughtful statement on the issue, and we appreciate that.

I will go to my colleagues. I think maybe if each person could just take a question or so and then move on. Senator Shelby.

Senator SHELBY. Thank you. Mr. Chairman, you and a lot of us on this committee have recently been to Latin America—I just want to share this with Mr. Williamson this morning—talking with a lot of people down there in various countries about this debt. I believe that it is a ticking time bomb, not only in Mexico but all the way to Argentina, and it is something that is not just going to go away. I don't believe that the debt is ever going to be paid back not at full value or even not close to full value, because there is a secondary market building out there.

How do we bring about, in your opinion, an international entity? It seems to me that that would be the best option that you mentioned this morning. What would be the mechanics of bringing this together to buy off this debt at a lower rate and try to bring about some internal reforms in these countries, you know, link it, and so forth. Would you comment on that?

Mr. WILLIAMSON. Well, certainly, one way of going about it is to create an IMF facility which could enable the countries themselves to buy back a part of the debt on the secondary market. That is something which I think is very practical. I have many doubts about the feasibility of creating an international organization which would set out to try and buy back all of the debt at something close to the present secondary market price, because I believe the secondary market price is a price at which most of the banks have chosen not to sell. Most of the banks are not prepared to sell at such a low price, so you then either have to try and force them to, which is legally very difficult—I don't think you would find that the courts would be sympathetic to that—or else you have to try and put the regulations in a way——

Senator SHELBY. Is there a difference between forcing them to and getting them to recognize the market value of this like anything else? There is a little difference there.

Mr. WILLIAMSON. Yes.

Senator SHELBY. Because the secondary market is creating a real market just like in any kind of——

Mr. WILLIAMSON. It has become quite a big market. I am not denying that. Nevertheless, it still is a fact that most of the banks have chosen not to sell at the price prevailing there, and that, I think, is because while they may not think that they are going to get back in present value terms all of the money, they think they are going to get back more than the equivalent 40 cents on the dollar or whatever it is at the particular time for a country.

The secondary market price is the price at which the marginal bank is willing to sell and not what the average bank necessarily thinks the debt is worth. That is why I see a problem in trying to force all banks to go into the market at the same price. So I think one wants to try and encourage the process, but on a voluntary basis.

Senator **Shelby**. Mr. Chairman, I want to defer to my colleagues.

Senator **Sarbanes**. Thank you very much. Senator Mack.

Senator **Mack**. Let me just ask the question that at least in my mind is fairly significant, and that is, what do we have to do or what has to happen to create an incentive for the banks to move? I mean, it is one thing for us to talk about recognizing the problem, and I have attended many conferences where we have discussed this. Recently down in Miami, the Miami Chamber of Commerce and the University of Miami held another one of its conferences. And the bottom line is, what is the incentive? I mean, how are we going to—what are they going to see that is going to make it worth their while to make this move?

INCENTIVES TO MOVE ON THE DEBT PROBLEM

Mr. **Williamson**. Well, I think many of the banks are only too anxious to sell, and the problem is that there is not enough demand.

Senator **Mack**. Let me broaden that. I didn't mean just the sale in the secondary market, but the incentive to address the entire problem. I think it is much broader in either writing down the debt or in—and again, I think that it is more too it than just writing down the debt. It is also lending additional capital in the future that is necessary to solve the problem.

What is the incentive for them to move from where they are?

Mr. **Williamson**. If I may just say, in the case of the Latin American countries, I am not sure that it really is true that they have to look to big inflows of capital. If they paid less net interest, whether it comes about through them paying less interest or paying the same interest and getting some of the money back, is not that important in the short run. It is important in the long run for whether the debt escalates out of control, but in the short run, both have the same effect. They are now transferring more than they are receiving in new money. So if you cut down the interest obligations that they have to pay, that in itself is sufficient to give relief. Now if you think of interest capitalization, and you ask the question, what would be the incentive for them to move along those lines—I think you probably would need to do something on the regulatory front in the United States. Many European banks do not have the same misgivings about interest capitalization, so with regulation reform and some official pressure, I think the majority of the banks could be presuaded to go along with it.

This is a relatively easy one, I believe, to handle a recalcitrant minority of banks that aren't prepared to move.

Senator **Sarbanes**. Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman. To follow up on a question of Senator Mack, there has been a sense in Latin America that the European banks have been more forthcoming in dealing with this issue than have American banks.

Do you believe that that is an accurate statement of the situation and, if so, why?

Mr. **Williamson**. I think it is probably true that the continental banks have been more forthcoming. I am afraid I am not quite sure the British banks have been a lot more forthcoming! I think the differences are primarily a result of the different accounting and regulatory treatment, and taxation as well. The differences here are quite major. I think at one extreme you have Germany, Switzerland, Spain, and at the other extreme, the United States, Japan, Canada, and the United Kingdom. The different attitudes are conditioned by different tax treatments and so on. So you can't just point to the banks for that. I think one does need to review the regulations.

Senator **Graham**. If I could ask a second question. There is an increasing sense of urgency that this problem is getting progressively, maybe geometrically worse as it is deferred. We also face the reality that other problems occur and get in front of or push this aside. When Mr. Baker made his speech in 1985, we weren't thinking about an S&L crisis. Now that is the dominant question, and this has sort of fallen into a second or tertiary position.

What would you recommend as a course of action that would give some accelerated attention to this? For instance, it has been suggested that rather than try to deal with this on a global basis that we look for solutions that can be guided by some general principles but applied on a country-by-country basis. There was an article in the Wall Street Journal Friday that used the concept of chapter 11 as a concept of isolating the particular debtor and dealing with it on a domestic basis, how those concepts could be applied internationally.

What could we do to see some positive action in the next 12 to 24 months?

Mr. **Williamson**. Well, in principle, the idea of creating a chapter 11 type mechanism at the international level is attractive, but it would require major international negotiations, new treaties, signing new agreements subject to that and so on. I think it is something that should be done, but as we emerge from the debt crisis rather than as a solution to this crisis. This one I think we have to try and fight our way out of in a more ad hoc way. The basic strategy that I outlined is to come in with some mechanism to encourage large-scale, relatively rapid debt reduction on the one hand, and on the other to bring some pressure to bear on the banks to agree to further postpone the debt service receipts. If they don't want to go in for debt reduction, then they have to do it by postponing in a much more formal way.

I agree that ought to be done on a case-by-case basis. Indeed, I don't think the concept of a case-by-case approach has ever really been very controversial. It is very difficult to find anybody who says they want to treat all debtor countries the same irrespective of their position or the merit of their policies. But on that issue, the big twist in policy that seems to me necessary at this stage is to stop saying we will do things to help you if you put in new policy reforms, and to say, look, some countries have been very serious about policy reforms. Ask Jeffrey Sachs, who will be on later this morning, and he will talk about Bolivia. Bolivia did more to deregulate the economy in one week than the United States did in the whole Reagan administration, and yet we don't give them very much reward for doing these things that we have been telling them to do.

Countries in this situation should be getting rewards, and that seems to me the biggest change we should make. Instead of saying, "If you promise to do good things in the future, then we will lend you some more," say, "Look, some countries have done the right things." Now we come in and really try to sort out their debt through a combination of these two mechanisms.

Senator **SARBANES**. Well, Mr. Williamson, we are pushing you up against your deadline. Let me take just a few more minutes, if members have a particularly pressing question they want to put. We have promised this witness to get him to his airplane, at least let him out of here early enough that he has a reasonable chance to get to his airplane.

Senator **BOND**. Thank you, Mr. Chairman. I am still not clear, Mr. Williamson, in reviewing your testimony and your answer, particularly, to Senator Mack's question, what you deem would be adequate to encourage the banks to participate in either interest capitalization or the other steps you recommend. At the beginning of your prepared testimony, you indicated that efforts to force debt forgiveness would obviously run into some real problems. The political undesirability of having major direct public subsidies from the United States are not great. You suggested that perhaps regulatory relief in the United States might encourage banks to do that.

Would that be sufficient incentive? Can we change the regulatory or accounting requirements to give the incentives for banks in the United States to participate in these plans, because without either attempting to force the changes or providing some public moneys to serve as incentives, I am concerned about what the proper incentive would be.

Mr. **WILLIAMSON**. I would distinguish between debt reduction and debt postponement in this context. I think debt postponement is where the regulatory treatment does become important. If you want the banks to do more than they have up to now, by, for example, interest capitalization above some cap based on export earnings, I think that probably is going to need some regulatory reform, plus direct encouragement from the Treasury and the Fed. With a policy lead and the regulatory encouragement, I think you could reduce that.

Now in the case of debt reduction, I look there primarily to making money or guarantees available, in order to be able to buy out a substantial chunk of the debt at the secondary market price.

Senator **BOND**. Thank you, Mr. Chairman.

Senator **SARBANES**. Senator Sanford.

Senator **SANFORD**. I am going to follow my chairman and urge you to move forward toward your airplane.

Senator **SARBANES**. Senator Wirth.

Senator **WIRTH**. I join your sense of urgency.

Senator **SARBANES**. Mr. Williamson, we very much appreciate your appearance, and we, I am sure, will be back to you. We appreciate your statement, and we have your earlier report. Thank you very much. I think you will make that plane all right. Good luck.

Mr. **WILLIAMSON**. Thank you.

SUPPLEMENTARY RESPONSES TO ORAL QUESTIONS OF SENATORS SHELBY AND MACK FROM JOHN WILLIAMSON

I believe it might be useful if I amplified my responses to two questions addressed to me during my testimony on February 8. One is Senator Shelby's opening question regarding the creation of an "international entity" charged with dealing with the debt problem (p. 20), and the other is Senator Mack's question concerning the incentives for the banks to address the debt problem (pp. 22-23).

An International Debt Authority

I believe that a clear strategy rather than the creation of a new institution is the key innovation needed to resolve the debt crisis. Nevertheless, once a strategy has been agreed, it would be helpful to charge some international entity with clear responsibility for implementing it. This entity might be one or other of the Bretton Woods institutions, or else some entity located in one of those institutions, or a joint facility of both IMF and World Bank.

If the agreed strategy were that recommended in my testimony, the entity charged with responsibility for implementation would need substantial capitalization or guarantee authority in order to promote debt reduction. A sum of at least $30 billion, and preferably $40 billion to $50 billion, would seem called for. Japan and perhaps other surplus countries might well be prepared to bear a disproportionate share of the cost, but I doubt if the United States could expect to get away with less than a 20 percent share. Of the various suggestions designed to limit taxpayer commitments to cover this cost, I like best Representative LaFalce's proposal to use the IMF gold stock as collateral and my own proposal to make temporary use of the World Bank's general capital increase to guarantee exit bonds.

The entity should be charged with facilitating comprehensive debt reconstruction designed to reduce contractual obligations to a level that can be paid without jeopardizing growth for countries that have implemented serious policy reforms. However, I remain skeptical about the feasibility of accomplishing this by getting all banks to make the same concessions, which is why my strategy involves giving the banks a choice between debt reduction and interest capitalization (or some equivalent debt restructuring). I would have grave reservations about an international debt authority whose mission was to pressure all banks into making uniform concessions or which involved treating all debtors in a uniform way.

Incentives for Debt Reconstruction

Many, but by no means all, banks would be willing to engage in debt reduction if the debtor countries had access to the cash or guarantees to undertake buybacks or to issue exit bonds. It is only proposals that would require all banks to engage in debt reduction that face an incentive problem on this score.

An incentive problem would arise, however, in persuading banks that do not engage in debt reduction to postpone an adequate part of their claims, preferably by capitalizing interest. I can think of three measures that would change the incentives facing the banks.

(1) The IMF could abandon its policy (so far modified only for Bolivia and Costa Rica) of requiring a debtor country to sign an agreement with the commercial banks in order to be eligible for a standby program. It should instead stand willing to conclude a standby program with a debtor country that was prevented from signing an interest capitalization arrangement because of obduracy on the part of the banks (requiring the debtor in the interim to pay the noncapitalized portion of interest due into an escrow account with the Fund). This would prevent the banks using a debtor's need for an IMF agreement to avoid conceding interest capitalization.

(2) At present a bank which lends "new money" equal to a fraction of the interest it receives is able to accrue the whole of the interest receipts into profits, while it is generally believed that in the United States capitalized interest would not under normal circumstances be eligible for accrual into reported profits but would nonetheless be counted as a part of taxable income. These arrangements are a deterrent to acceptance of interest capitalization by US banks. The best way of removing the discrimination against interest capitalization would be to permit the exclusion of capitalized interest from taxable income as well as reported income. This would obviously have some cost in terms of tax revenue, especially in the short run before the loans had been written down to zero on the books.

(3) Failing that, the discrimination could be eliminated by:

(a) requiring that new money be counted as a charge against profits, or

(b) allowing capitalized interest to be accrued into profits.

Either of these changes would ultimately be dependent on acceptance by the accounting profession, but a strong lead by the regulators with support from the Securities and Exchange Commission could probably secure the adoption of one or the other. (The danger of this approach is that if the accountants chose the first alternative and the banks still resisted interest capitalization, it would be more difficult than ever to assemble new money packages.)

If used to back up pressure for interest capitalization from the US Treasury, the Federal Reserve, and the financial authorities of other countries, these changes should suffice to persuade an adequate majority of the banks in each syndicate to go along.

Senator **Sarbanes**. If the first panel would now come forward and take their places. Rodney Wagner, Rodrigo Botero, and Harry Freeman.

I appreciate the forbearance of my colleagues in deferring any opening remarks, so we could hear Mr. Williamson, and I think now we will turn to that before we hear from this panel. My intention, once we turn to the panel, is to hear from each member of it for approximately 10 minutes each and then go to questions. So we will hear all of the members of the panel first before we go to a questioning session, but before we turn to the panel, I will turn to my colleagues in the order in which they came this morning. So Senator Shelby.

Senator **Shelby**. Mr. Chairman, I have an opening statement with an article attached that I would ask unanimous consent to be part of the record.

Senator **Sarbanes**. It will be so included.

[The complete prepared statement of Senator Shelby follows:]

OPENING STATEMENT OF SENATOR RICHARD SHELBY

Senator **Shelby**. Mr. Chairman, I appreciate your calling this hearing. I believe that you and I share a keen interest in the Third World debt issue. I mentioned to you just a couple of weeks ago that I would really like to see some hearings held on this subject; I don't know if this hearing was in the works at that time or if you scheduled it since then, but I appreciate your putting a hearing together so expeditiously. I also appreciate the witnesses for agreeing to appear on relatively short notice.

Mr. Chairman, I was part of a recent trip to Latin America and several of the debtor nations. The focus of my attention was the debt crisis and I had the opportunity to meet with several high level government and private sector officials, who are very familiar with the issue.

I returned to the States having learned a lot. Some of my earlier impressions were simply confirmed. It was my belief before I made the trip and it is my belief now that I have spoken with those on the debtor side of the issue, that a lot of the money owed commercial banks and to the public sector is never going to be paid back. I believed before I went that the secondary market valuations for LDC debt were probably correct, at least as ballpark figures. This too was confirmed by the conversations I had during my visit.

However, during this period of study, I learned some interesting things about the debt. I had the opportunity to learn more about private flight capital. It is now my understanding that a significant percentage of the money loaned to some of these less developed nations went right out the "back door". While the governments of these nations still bear the responsibility of paying back their debts, many of the assets were "privatized and expatriated." Much of what I learned in conversations was similar to information I found in an excellent article on this subject by James Henry, for the Washington Post. Mr. Chairman, if I may, I would like to have this article made part of the hearing record. Thank you, Mr. Chairman.

From Mr. Henry's article I learned that in Argentina, as much as 70 percent of the money loaned went to purchase private investment in other countries. In Mexico, 51 percent of the money borrowed flowed to outside investment, while in Barzil a paltry 20 percent of the capital left the country. In total, the worth of Third World flight assets is now estimated to be around $600 billion, largely because the income earned on these investments is almost entirely reinvested and is, to a great extent, tax free.

Mr. Chairman, this means that the private sector of every major Latin borrower has nearly enough assets abroad to more than pay off both public and private sector debt, even at face value. If you price the debt at its secondary market valuation, the flight assets exceed the value of the debt by a wide margin.

In this same article, an anonymous Citibank banker, speaking of Mexico, said that the debt owed Citicorp could easily be repaid by the Mexican privately owned assets in Citibank's New York and Geneva offices. But the ownership of these assets is in the hands of a privileged few; obtaining access to these assets is a virtually impossible proposition. I am sure I am not the only one reminded by this scenario of the fraud that precipitated the S&L crisis; the assets are in the hands of a wealthy few and the debt is left to be repaid by the Government.

In my opinion, the flight of capital is one of many things that needs to be addressed further. The Third World debt crisis is one of utmost importance. The strength of the U.S. economy and the economies of our Third World trading partners are inextricably linked. The Third World purchases more than one-third of American exports. The austerity programs adopted by debtor nations have drastically reduced our exports to these countries and we have lost an estimated 340,000 American jobs. The staggering amount of debt yet owed American commercial banks seemingly imperils the security of our financial system and subsequently threatens the deposit insurance system, and the U.S. Treasury.

There are national security concerns as well. The austerity programs of the past decade have caused economic hardship for the majority of the citizens of our Latin American neighbors, many of whom have little or no understanding of their nation's external financial obligations. Leftist parties in countries like Brazil and Argentina are gaining popularity for their opposition to austerity measures and debt repayment. The recent election in Mexico and the slim margin by which President Salinas was elected indicates that Mexican citizens are growing tired of cutting back and going without. Our border with Mexico is more than 2,000 miles long, and as one of our witnesses points out, is the only border in the world between a major developed country and a major developing country. Obviously, instability and unrest within our southern neighbor poses a different kind of threat to U.S. interests.

I feel we are at a stopgap in our policy on Third World debt. The Baker plan and a modified Baker plan have not worked. Net capital outflows from debtor nations have precluded the possibility for economic growth. The declining standard of living in debtor nations and the subsequent economic unrest cannot continue if democracy in these nations is to be sustained. U.S. interests are best served by formulating a policy that permits our debtors to grow out of their problems, while preserving peace and stability.

The Bush administration is currently reevaluating their policy on Third World debt. Though Bush promises a "whole new look", we are well aware that the new administration faces more than one tough issue at this time. LDC debt policy may well take a back seat to more pressing domestic financial matters. For this reason, I would like to see Congress provide direction in this issue.

I believe that today's hearing will be very helpful and I hope that we can continue this series in the upcoming weeks.

Thank you, Mr. Chairman.

Senator **SARBANES**. Senator Mack.

Senator **MACK**. I don't have any statement to make at this time.

Senator **SARBANES**. Senator Graham.

Senator **GRAHAM**. Mr. Chairman, I have an opening statement that I would like to file for the record. The article that I alluded to is from the February 3 Wall Street Journal.

Senator **SARBANES**. Is that this "Chapter 11 Workouts for Latin Debtors" by Shafiq Islam of the Council of Foreign Relations?

Senator **GRAHAM**. Yes.

Senator **SARBANES**. It will be included in the record.

OPENING STATEMENT OF SENATOR BOB GRAHAM

Senator **GRAHAM**. Mr. Chairman, let me commend you on this hearing today to review the many thoughtful proposals on Latin American debt. This morning's hearing will help to focus our attention on the problem in conjunction with the review going on at the Treasury Department and before Treasury's presentation to us on the review of the debt issues in the 1988 trade bill.

An approach to Latin America in the 21st century begins with an appreciation of the mutuality of interests, and projects a sense of common purpose into the future. Questions which need to be asked include "what type of hemispheric relations would the United States like to have with our neighbors?" Not just in the next 6 months or year, but in the year 2000 and beyond. "What are the characteristics that we would judge to constitute success in U.S. political and economic relations within this hemisphere?" I would suggest the following:

Politically, by the year 2000, we should be looking toward a strengthening of those emerging democracies in countries such as Brazil and Argentina. And the establishment of democracies in those handful of countries in this hemisphere which still live under authoritarian rule, in Cuba, Nicaragua, Chile, and the other countries which today are the exceptions in this hemisphere in terms of having a government which is responsive to the people.

The United States needs to be concerend about our national security position as it relates to Latin America and as to economics, this time needs to be a period which reverses the pattern of the last 10 years in terms of economic decline in Latin America and substitute a period of strong economic growth. We need to look for an increased cultural relationship among our people and on the very difficult issue of drugs, we need to see this as an opportunity for a joint and sustained effort among the democracies of this hemisphere—to attack this problem both on the supply and demand side through a concerted hemispheric effort.

As to debt, our goal should be to achieve an economic environment under which these nations can reasonably meet their debt service requirements and have sufficient new investment to stimulate the economic growth which their population requires.

A basic general principle, is to separate the thinking about the old debt from the thinking of how we are going to get the necessary new investment in Latin America. Looking at the old debt we need to place United States financial institutions on a parity with our Japanese and European counterparts in the ability of United States financial institutions to deal with this issue and we should make it easier for Third World nations to buy back their own debt in either the primary or secondary market.

In terms of new debt, I believe that the approach to dealing with the new investment which is required has many similarities to how this Nation dealt with the question of providing new capital for housing in the period particularly after World War II, in the form of loan guarantees.

I believe we should create or assign to an international institution the task of guaranteeing loans to other international institutions or to private commercial institutions which should be contingent upon the agreement of that country to the acceptance of economic reforms which have as their objective assuring the economic growth which will allow the countries to meet their needs and service their external debt will be achieved in terms of creating an environment in which there will be the new capital necessary for economic growth in Latin America.

Mr. Chairman, I look forward to the testimony this morning and this subcommittee's continuing dialog on Latin America debt.

Thank you, Mr. Chairman.

Senator **SARBANES**. Senator Bond.

Senator **BOND**. I'll pass.

Senator **SARBANES**. Senator Sanford.

Senator **SANFORD**. I do have a statement that I would like to be inserted in the record.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator **SANFORD**. Thank you Mr. Chairman, for calling for this hearing and a special set of thanks to our witnesses and the groups they represent for their excellent work in preparing such informative and innovative reports on the Third World debt problem and what we should do about it.

It is also a particular pleasure for me to welcome Rodrigo Botero to this committee. For the past 2 years, Rodrigo has served on an International Commission for Central American Recovery and Development that I have been very involved with. The Commission's final report will be issued later this week in Guatemala and I would like to take this opportunity to thank Mr. Botero for all his excellent work with the Commission.

The Commission is made up of experts from all over the world, with the majority of members coming from Central America. The Commission has been working to develop a regional plan to the resolve the social, political and economic problems of Central America. The plan developed by the Commission is one proposed from the region, not one imposed upon it.

As we all can understand, the need for debt reduction and restructuring is a very important element of this plan. With export growth declining and economic activity in a slump, levels of debt and debt service have climbed to unacceptable levels. Central American debt service payments rose from consuming 12 percent of exports in 1980, to 40 percent in 1987. Central America, like so many other regions with severe debt problems, must obtain some relief from its debt service obligations if it is to diminish its need for foreign assistance, and permit the region's governments to enact effective adjustment policies. It is only through the establishment of such adjustment policies that sustainable development will be possible.

I am sure that the problems of Central America are repeated throughout the Third World. Again, I appreciate the fine work that our witnesses have done to provide an analysis of and proposed solutions to the Third World debt problems and look forward to hearing their testimony.

Thank you, Mr. Chairman.

Senator SARBANES. All right. Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, let me first apologize to the committee for being late this morning. I am still working on the old bailout, the bailout of the savings and loans. One bailout is about all I can deal with at one time, and I suspect it is all that the taxpayers can afford.

This is a very important subject matter, Mr. Chairman. I congratulate you for holding hearings on it. I think it is an area where we need new thinking. Any idea that we have a bottomless pot that we can reach into and bail out people, who have accumulated debt without also creating capital to service the debt, is unrealistic. Unfortunately, much of this debt is to the American taxpayer, much of it is to the private sector. I feel that it is imperative, since this so-called debt crisis is now 6 years old, that we come to grips with it. I think it is unrealistic for us to continue carrying Third World debt for auditing purposes on the balance sheets of commercial banks as if it were IBM stock.

I think that at some point, that our audit process and the regulatory process of our financial institutions have to reflect reality.

I think it is also clear that debt is not inherently bad. We were a debtor nation from the time the first Pilgrims stepped on Plymouth Rock until about 1920. We borrowed our way into being a world power, because the debt was accumulated with private equity investment helped build America and make us the richest and most powerful Nation on Earth.

The problem with most Third World debt is that it has gone to governments that have spent the money basically in a nonproductive way and not developed the capacity to repay it. Many of these countries could generate that capacity by substantially changing their economic systems. There was a time when we played this little game that countries could develop in their own way and with their own cultural approaches, but I think if we have learned anything in the post-War period, it is that there is only one way to have economic growth. And my opinion is, if we are going to give any help with Third World debt, that we ought to give it only to those who demonstrate that they deserve it by making the changes in their economy that will be necessary in order to be economically successful.

So Mr. Chairman, I delight in being here.

Senator **SARBANES**. Senator Wirth.

OPENING STATEMENT OF SENATOR WIRTH

Senator **WIRTH**. Thank you, Mr. Chairman. I am delighted that you are holding these hearings. I think it is extremely important that we in this committee, as well as others in the Senate, begin to get a handle on this issue.

I had the privilege of leading a Banking Committee trip for 2 weeks to South America in January. Senator Shelby was on all of that trip, Senator Heinz on a good deal of it, and others from the Congress also participated. We were there to focus on the issue of debt and the issue of environmental problems, and to see if there was a mix is solutions that we might be able to explore between the two.

A number of things came out loud and clear. On the one hand, if we are not careful, the politics of the debt situation can end up with the United States and other creditors being treated as whipping boys, and that whipping action could become a substitute for the sort of needed reform that is absolutely imperative in many situations. We have to be careful to avoid playing into that as we discuss the debt issue, and not allow alienation or hostility toward the United States to become that sort of substitute. I think, we have to be very sensitive in thinking about the conditions in the debtor countries.

Second, there is no question about the fact that as Senator Gramm was suggesting, our policy and the way in which we deal with the debt has to change, just as these countries do. The enormous market in South America, in particular, which has been so important for us, historically, is one which that we are losing rapidly. It is no longer a dominant marketplace for us, as it once was. While we are foundering in our policy, we are watching a number of other countries start to move in and recognize the potential in South America. And I think in particular of the Japanese. As I understand it, the Japanese are currently, for example, very close to funding a major highway that will move over the Andes from Peru into the back of Amazonia, which will cause an enormous change to the economics of Brazil, an enormous change to the economics of South America.

The Inter-American Development Bank and the World Bank have said that they are not going to fund that road, but the Japanese are merrily moving ahead to open up that road, which would result in enormous environmental damage and cause major significant worldwide crises related to air, water, and species diversity. But beyond that, the road will open up and really change the economic face of South America. And I would guess that we know very, very little about that; we have not focused on that. Plans to develop the road came as a surprise to us during our trip. As we began to find out about this and probe it, the size, scope, and importance of this highway became more and more important.

This situation is just one example of a market in South America that could be rapidly opening up, and something that we have to understand better.

Finally, Mr. Chairman, I think that we have to be very creative in looking at the potential of various debt-swap examples that have occurred in a small way in some places, and which could be very creatively expanded and used elsewhere. We made a proposal which you and I talked about, Mr. Chairman, to the Government of Brazil in a very tentative way, that has started to move rapidly, in terms of converting some discounted debt into a major foundation that would be run by the Brazilians under Brazilian law, respecting the sovereignty of Brazil. Income from the foundation would in turn spin off to allow management of rain forest reserves that the Brazilian Government wants to set aside but doesn't have the funds to manage. The foundation also would support various research programs, both on the biology of what is in the rain forest and also on the commercial potential of extractive reserves, and a whole variety of challenges and opportunities that we face.

So I think as we look at the debt issue, it has a down side, yes, but it also has the potential of some very creative approaches for us and for the countries of South America, particularly Brazil, to look at the environmental and research and other rain forest issues that are reaching crisis proportion.

I would take just a few minutes, Mr. Chairman, only to note the importance of our trip and how much all of us who were on it learned and how much potential there is for us to move rapidly and creatively. Looking at the down side of the problem we have here can indeed be an up side.

Thank you very much, Mr. Chairman.

Senator **SARBANES**. Thank you, Senator Wirth. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator **HEINZ**. Mr. Chairman, I want to assure you, just because I am speaking just after Senator Wirth, we didn't plan it this way, but were on this trip together, along with Senator Shelby, and I would like to second Senator Wirth's comments and make this observation.

The distinguished group of witnesses that you have brought here today, both in this panel and the next, I hope would give their best thinking to the proposition of how we can encourage the lenders, the borrowers, and the international institutions to recognize that sound environmental conservation and conservation policies are fully consistent with the development goals of virtually all LDC's, that one of the most destructive activities that we saw going on in Brazil, for example, was this series of incentives to continue to cut down rain forest, which was cut down for farming purposes and the soil leached away within a year and the land, for all intents and purposes, was cleared of everything valuable. What was valuable was burned or left to rot. The farmer who cleared the land found that he was left holding a pretty worthless bag, and the result is that as far as we could tell, a policy decision by the Brazilian Government, which they are perfectly entitled to make, had really further impoverished the country.

Now that is not good for the people; it is not good for their status as a borrower; it is not good for the lenders. And it would seem to me that both the international borrowing and lending community have a great interest in working together to change policies that are counterproductive. One way to do that would be for lenders who go through a process, periodically, of rescheduling, rolling over debt, being patient on interest payments, forbearing, whatever management techniques you want to think about. There is an opportunity as those loans come due to try and get the borrower to adopt sounder overall economic policies, and this is obviously something that the World Bank and the IMF have to be involved in.

So far, the IMF has probably been more of a problem than it is part of the solution. At the same time, there is an opportunity, if you want to think of that as kind of a very soft stick approach, to consider a carrot at the same time, so it is balanced by holding out the possibility of some kind of donation of written-off debt for a debt-for-nature swap. I would hope that it would be possible through this hearing and through subsequent work to develop a set of policy initiatives involving the lenders, both private and public that will be attractive and in the self-interest of the borrowers to take advantage of it.

Thank you, Mr. Chairman.

Senator **Sarbanes**. Thank you very much, Senator Heinz.

Before we begin, I have a statement from Senator Dixon for insertion in the record.

STATEMENT OF SENATOR ALAN DIXON

Senator **Dixon**. Mr. Chairman, I am pleased to be here this morning as the subcommittee conducts oversight hearings on the Third World debt problem. We have a strong group of witnesses before us this morning, and I look forward to their testimony.

At the outset, I would like to make only a couple of brief comments. First, as Chairman Seidman of the FDIC has pointed out, the Third World debt problem no longer represents a systemic threat to the U.S. banking system. American banks have cut their exposure and increased their reserves and capital, and so our banking system does not face risks it cannot handle from potential defaults.

On the other hand, the national security, foreign policy, and trade policy ramifications of the crisis are more serious than ever. Brazil's inflation rate, for example, is over 1,000 percent—a phenomenon that works to undermine political stability there. Economic growth and unemployment rates in Mexico, a country crucial to American interests, are very disturbing.

Further, the persistent crisis has undermined our trade relationships with many Third World countries. This costs us American jobs, and economic development here at home.

What this all means is that we need to change our policy. We sent a clear message in the trade legislation adopted in the last Congress that such a change is essential—the distinguished chairman of our subcommittee, Senator Sarbanes, led the fight to get the omnibus trade bill to address this serious issue. I think our chairman is right; we need to act now, and I look forward to working with him and my colleagues on the committee, and with the administration and other interested parties to see that we get the change in policy that is so essential to our own national interests.

Thank you, Mr. Chairman.

Senator SARBANES. Our first panel reflects or will address three reports that have been issued, which either in part or in full touch on this subject:

The Third World debt panel, the Economic Policy Council, of the U.N. Association of the U.S.A. And I would say to the members, we've gotten copies of these various reports and they are at your places. This is the one of the Economic Policy Council of the U.N.A.-U.S.A., which was cochaired by Tony Solomon, president of S.G. Warburg and former New York Federal Reserve Bank Chairman, and Rodney Wagner, vice chairman of the Credit Policy Committee of Morgan Guaranty. The panel issued a report last September, September 7, calling for reexamination of a long-term management of the debt problem, and we are pleased to have with us this morning, Rodney Wagner of Morgan Guaranty, the cochair of this panel, to address this report.

The American Agenda, which was chaired by former Presidents Ford and Carter, issued a report in November, which covered a wide range of subjects, but which included within it a section entitled "It Is Time for a Major New Effort to Resolve the International Debt Problem." That is this report of the American Agenda, which members have before them. And we are pleased this morning to have Harry Freeman, the executive vice president of American Express, who will present the findings of the American Agenda group.

James Robinson, the head of American Express, was a very active member of the American Agenda group.

The third report that will be addressed by this panel is the report of the Inter-American Dialogue which has just been issued. The Americas in 1989 Consensus for Action. It addresses a number of issues involving the Americas, but the lead chapter is given over to the debt question. "Debt and Stagnation: A Program for Recovery." And we will be hearing from Rodrigo Botero, representing the Inter-American Dialogue, who is currently a visiting scholar at the Harvard Center for International Affairs, and former Finance Minister of Colombia.

I might say, just to go back to Mr. Williamson, of the Institute for International Economics, there is first the report that Mr. Williamson did back in the fall, "Voluntary Approaches to Debt Relief," and Fred Bergsten, the head of the Institute, has just come out with a book entitled "America in the World Economy: A Strategy for the 1990's," a chapter of which is devoted to "Third World Debt and Burden Sharing: Mobilizing the International Financial Institutions."

So by that, by way of laying some basis, we will turn now to our first panel.

Gentlemen, let me say to you that I think it is a demonstration of the interest which this issue is attracting that you have had—Senator Dixon was here earlier and had to leave—but you have had 10 Members of the U.S. Senate here with us this morning to address the issue. And I want to make one final reference to a column in this morning's Washington Post by Hobart Rowen, entitled "Biting the S&L Bullet," and giving a good deal of—more than a good deal, actually, quite a bit of praise to President Bush for coming to grips with the S&L issue, which was, I think, the standard statement in this committee yesterday, when we heard a hearing, by the members, in terms of the President coming up to the issue.

And further on in this column this morning, it goes on to say, this is about the President: "He must quickly come to grips with two related issues, leveraged buyouts and Third World debt." And makes reference to the fact that the President had earlier said "that a review of the failing Baker plan is a top priority and set three Federal agencies the task of looking into the strategic as well as economic consequences of economic deterioration in key Latin American countries."

Now the Treasury has to submit a report, as I indicated earlier, by the end of the month—before the end of the month, and of course, that will attract a great deal of attention and focus.

With that, we are prepared to go to the panel. Mr. Wagner, why don't we start with you, and we will move right across to Mr. Botero and then to Mr. Freeman. If you could each take 8 to 10 minutes, we will include your full remarks in the record, and then we will go to questions from the committee.

STATEMENT OF RODNEY B. WAGNER, VICE CHAIRMAN, CREDIT POLICY COMMITTEE, MORGAN GUARANTY TRUST CO., CO-CHAIRMAN, ECONOMIC POLICY COUNCIL OF THE U.N. ASSOCIATION OF THE U.S.A., NEW YORK, NY

Mr. WAGNER. Mr. Chairman, members of the committee, I first want to convey Tony Solomon's regrets that due to an unexpected illness in his family, he is unable to be here today to testify, and I am substituting for him. I have not had time to prepare a written statement, but I will submit one shortly to your committee staff.

Tony and I cochaired the panel that the chairman described, and we did issue the report in September of last year. I will run through some of the principal thoughts that came out of that panel.

First of all, we found that progress by lesser developed countries, which I don't think is any surprise to any of you, has been slow and many have not done well. There was concern by the panel that the fragile consensus among debtor countries, commercial banks and major creditor countries built since 1982 could well fracture and that the cost to both creditors and debtor countries would be high. A solution to the debt problem and economic recovery will require both domestic reforms and reduction of the resource gap in these countries. This resource gap, we found, is unlikely to be bridged in most cases by the current level of new lending that has been provided by the banks.

The panel then focused on the debt problem and came up with several general principles.

First was that the need for active leadership from the governments of major industrial countries and by the multilateral institutions whose policies they largely set.

Second, continued structural reforms by LDC's are absolutely essential.

Third, a resource gap does exist and must be met if growth is to occur.

And fourth, we found that debt service reductions should be given more attention.

The panel then examined the shortfall in resources, and this became a central focus of the panel. To us, there were two routes. You can get more new money for these countries or reduce the amount of money that is being paid out.

NEW MONEY

New money has been successful in some cases. Brazil, for example, concluded a $5.2 billion program in 1988 that included the usual pattern, the World Bank, IMF, Paris Club, the banks; however, new money from banks is becoming increasingly difficult to get. We found that strategies have changed: U.S. banks, many of them are concerned now with their domestic markets, and in Europe banks are turning to planning for 1992; better reserves for bad debts and stronger capital positions have put many banks in a situation where they are able to turn away from any new money participation; risk-based capital requirements; tax and accounting rules also have not helped to encourage banks to come up with new money.

All of these made it increasingly difficult to marshall the funds that are needed for this problem.

Banks also pushed for some enhancements, and in this process, there was some work on trying to stimulate new money by working in the direction of more cofinancing programs with the World Bank, guarantees, cross-default arrangements. This has not been successful. A limited amount of this has been done, but it has not created a significant flow of new moneys.

So given all the difficulties in finding new money going in to continue the process, we looked closer at the other side of the formula we were talking of, which is really debt service reductions.

These are already happening in various forms. They have been going on in the form of debt-equity swaps, which has been particularly effective in Chile. There have been private sector debt-for-debt swaps, and these have been used in Mexico, Argentina, Brazil, and in some cases, are quite large. Exit bonds, which have been slow in developing. The most recent case has been in Brazil and had some success. And there are debt buy backs, which have been done by Bolivia and Chile. There are also some nature swaps which Senator Wirth and Senator Heinz mentioned. Though these have been used infrequently, we believe these can be expanded. Right now it is more attractive for banks to sell their debt than to donate it, and with a shift in tax treatment to make a debt donation a tax credit, we believe this would open up the flow of money into these nature swaps.

Often where you want to do a nature swap, is with a country where the debt has been written off, so it isn't available to donate. Also, you have to make it as attractive to donate as it is to sell, and right now it is more attractive for a bank to sell its debt than it is to donate it.

Senator WIRTH. What is the leverage to do that again?

Mr. WAGNER. Well, if you could arrange that anybody who donated their debt, would receive a tax credit. Right now, what happens is that if you take your debt and you sell it, you take a loss on it, and that you use for tax purposes. You do the same thing if you donate. You come down to the price at which you donate. But when you donate, it is just a tax deduction. If you sell it, you get cash and you are ahead of where you would be if you donated it.

Debt for trade is another process that has been used, though infrequently. These are very difficult to work out. It has been done in Peru a little bit—it is being contemplated in Brazil.

Now any of these swaps, what they are really based on is, an exchange is being made, and it is an exchange of bank debt for a different instrument. And that different instrument has to have some sort of value to it that makes it attractive for a bank to make the swap and make the swap in such a way that it is a discount for the country and the country benefits from it.

DEBT-TO-DEBT SWAPS

We spent most of our time in focusing on the debt-to-debt swaps and particularly the swaps made of government debt rather than private sector debt. The swap can be done two ways. You can either swap it on a discount basis. In which case, you are reducing the amount of debt outstanding, and therefore, you reduce the amount of interest that is going to be paid, or you can do what is known as a FASBE 15 debt restructuring, where you swap on a par basis, but you reduce the interest rate. Either way, you can get the same result.

But the key to a successful debt swap is the enhancement. What is a bank getting for doing the swap? Why would they do the swap? And we believe that this can be done by some guarantees of principal and/or interest. Some combination of this to make it work. The panel believed that to be successful, these swaps must be done on a voluntary and negotiated basis and on a case-by-case basis.

We also looked at some of the global schemes that have been proposed, and our conclusion was that really they are just too complex to be practical. When you get into what you have to do going across jurisdictions, both accountingwise, regulatorywise, taxwise, between countries, it becomes an extremely difficult proposition.

We came up with our final conclusions, which are 6 in number.

1. The element of government leadership is essential and is needed.
2. Structural reforms by the LDC's is essential.

3. Resource gap for some may be too great to cover with economic reforms, and governments and banks must work in concert to close the gap.

4. We urged that the U.S. Congress approve the contribution to the World Bank toward capital increase.

5. The panel believes that voluntary debt service reduction should be pursued as a serious alternative or component to more lending with official encouragement and support when appropriate.

6. The recognition that if debt reduction is carried out cooperatively and voluntarily through negotiation and mutual agreement by the principal parties, it would have the desired effect, not only of reducing outstanding claims against a country but of aiding economic recovery and bringing about creditworthiness.

Thank you for inviting me to be here this morning.

[Complete statement of Mr. Wagner and report of the Economic Policy Council follows:]

TESTIMONY BY RODNEY B. WAGNER

VICE CHAIRMAN CREDIT POLICY COMMITTEE
OF
MORGAN GUARANTY TRUST COMPANY
OF NEW YORK

Before the

SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY

Of the

U.S. SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS

FEBRUARY 8, 1989

Mr. Chairman and members of the Committee, first I want to convey Tony Solomon's regrets that due to an unexpected illness in his family he is unable to be here today to testify, and I am substituting for him.

Together we co-chaired a panel on Third World Debt during 1988 that was organized under the auspices of the Economic Policy Council of the U.S. United Nation Associates. The panel consisted of 29 members and included executives of commercial banks, investment banks, legal and accounting firms, labor unions and several senior officials from multilateral institutions and debtor countries serving in this own capacity. We had six meetings and a report was published on September 7, which was the result of this group's deliberations. Copies of the report have been provided to your staff.

For the benefit of those who have not had the opportunity to read the report, I will briefly summarize it.

Progress by the Lessor Developed Countries has been slow and many have not done well. There was concern by the Panel that the fragile consensus among debtor countries, commercial banks, and major creditor countries built since 1982 could well fracture and that the costs to both creditor and debtor countries would be high. A solution to the debt problem and economic recovery will require both domestic reforms and a reduction of the resource gap. This resource gap is unlikely to be bridged in most cases by the current level of new lending.

The panel focused on the debt problem and came up with four general principals:

1) The need for active leadership by the governments of the major industrial countries and by the multilateral institutions whose policies they largely set.

2) Continued structural reforms by the LDC's are essential.

3) A resource gap exists and must be met if growth is to occur.

4) Debt service reduction should be given more attention.

The panel then examined the shortfall in resources and this became a central focus of the Panel. To us there were two routes - new money flowing into the countries or reduce the amount being paid out.

New money has been successful for some. Brazil concluded a $5.2 billion program in 1988 that included the IBRD, IMF, Paris Club, and the banks. However, new money is becoming increasingly difficult to get: Strategies have changed - in the U.S. many banks are concentrating on the domestic markets, and in Europe 1992 is fast approaching; larger reserves for bad debts and stronger capital have positioned some banks to turn away from and new money participations; risk based capital requirements; and tax and accounting rules also have not helped.

All of these make it increasingly difficult to marshal the funds needed.

Banks also pushed for some enhancements on new money from multilateral agencies. This was done through co-financing, cross default provisions, and guaranties, but there has been of limited success partly due to concerns over appearing to "bail out the banks".

Given the difficulties in continuing new money programs, we looked closer at the other way to close the gap - debt service reductions. These are already happening in various forms:

1) Debt for equity swaps, which Chile uses extensively.

2) Private sector debt for debt swaps - used in Mexico, Argentina, and Brazil.

3) Exit bonds, as in Brazil.

4) Debt buybacks used in Bolivia and Chile.

5) Nature swaps - though used infrequently, these could expand.

6) Debt for trade - a few were done in Peru and now provision has been made for these in Brazil's latest program.

All of these require exchanging bank debt for an instrument of added value.

Of these we focused particularly on debt for debt swaps. The swap can be done at a discount or at par with a reduction in the interest rate. In either case, the debt service drops. The key to a successful debt swap is enhancement of the new debt instrument. This can be done by a guarantee of principal and/or interest.

To be successful the Panel believes these swaps must be done on a voluntary and negotiated base, case by case. The Panel believes any global approach is too complex to be practicable.

The Panel was concerned with how conditionality can be maintained once a debt reduction program has been completed. This is difficult to do, but we believe these countries will have ongoing needs for financing and these will provide opportunities for review of progress made or not made as the case may be and a refusal of future funding.

We came down to six conclusions:

1) Governments need to exert strong leadership.

2) Structural reforms by the LDC's are essential.

3) The resource gap for some may be too great to cover with economic reforms, and governments and banks must work in concert to close the gap.

4) The Panel urged the U.S. Congress to approve the U.S. contributions to the World Bank's general capital increase.

5) The Panel believes voluntary debt service reductions should be pursued as a serious alternative or compliment to more lending with official encouragement and support when appropriate.

6) Recognition that if debt reduction is carried out cooperatively and voluntarily through negotiation and mutual agreement by the principal parties, it would have the desired effect not only of reducing outstanding claims against a country, but of aiding economic recovery and bringing about "creditworthiness"

Thank you for this opportunity to be here today.

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THIRD WORLD DEBT: A REEXAMINATION OF LONG-TERM MANAGEMENT

Report of the Third World Debt Panel of the
Economic Policy Council
of UNA-USA

September 7, 1988

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ECONOMIC POLICY COUNCIL

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A REEXAMINATION OF LONG-TERM MANAGEMENT

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The Economic Policy Council

United Nations Association of the USA

UNA-USA Publications

INTRODUCTION

In January 1988 the Economic Policy Council of the United Nations Association (UNA-USA) invited a distinguished panel of experts to review the international debt situation. Among the panelists and participants were executives of commercial and investment banks, debtor governments and multilateral institutions, legal and accounting firms, and labor unions, as well as members of the press and academe.

It was not the intention of the group to reach agreement on one comprehensive plan or to add to the long menu of debt restructuring options now available. Rather, the panel sought to identify a core set of approaches that best meet the needs of debtor countries, creditor banks, and official institutions. The group met regularly over a period of six months before drafting its final report and recommendations.

Despite the great diversity of interests represented on the panel and many disagreements on specific issues, there was in the end a convergence of views on the nature of the obstacles to a successful resolution of the debt problem and on the general direction future debt policies should take. Not every panel member subscribes to every point in the final report, but its analysis and broad thrust are accepted by the panel as a whole.

The EPC embarked on this project with a sense of urgency, aware that the fragile consensus among debtor countries, commercial banks, and major creditor countries built since 1982 could well fracture and that the costs to both creditor and debtor countries would be high.

Some debtor countries have shown signs of economic recovery, with back-to-back years of substantial growth and increased exports and imports. But all troubled debtor countries remain vulnerable to changes in the world economy. The two percentage point rise in LIBOR[1] since the beginning of this year will add at least $8 billion per year to the debt servicing costs of capital-importing developing countries,[2] and further increases may be in store. Rising commodity prices--one of the sources of inflationary pressures pushing up interest rates--will offset the rise in debt servicing for some countries, but not for all. Recession in the industrial countries could curtail demand for exports of the least-developed countries (LDCs). Further interest increases or a slowing of industrial country growth could make it difficult for even some of the stronger troubled debtor countries to make their payments. The international financial community must prepare for such a possibility.

---

[1] London Inter-bank Offered Rate

[2] Excluding the high-income oil-exporting developing countries.

Even assuming favorable global economic circumstances, the current outlook is for sporadic progress for some debtors, periodic interruption of payments by others, and increasing reluctance on the part of many commercial banks to lend to troubled debtors.

The political climate in some debtor countries is becoming more uncertain. A radicalization of politics revolving around the economy and what to do about the debt is apparent in several countries. Even as these governments are seeking negotiated solutions to their debt problems, they face growing popular frustration with continued austerity and resistance to continuing an accomodative stance toward foreign creditors.

Over time, a situation in which a significant number of countries are in intermittent arrears or on the brink, can undermine the integrity of undercapitalized banks and weaken the fabric of the international financial system as a whole.

Ultimately, the debt is not just a problem for banks and debtors but for the global community. A massive payments imbalance between the United States and other industrial countries has introduced an element of fragility in the world economy. As the industrial countries begin to adjust these imbalances, the unrealized growth potential in the troubled debtor countries takes on much greater significance for the rest of the world.

The global consequences of the Third World's economic strains were held in check to an extent by the strong performance of the U.S. economy after 1982. The industrial countries lost export markets and jobs because of the debt crisis, but strong demand for imports by the U.S. more than offset these losses. U.S. exports to Latin America fell by roughly a fourth after 1982, but the jobs lost were replaced by new jobs created in our domestic sector. The European Community, which exported $20 billion less to Latin America in 1986 than in the peak year 1981, exported $34 billion more to the United States in the same year. Japan exported $1.4 billion less to Latin America but shipped $43 billion more to the United States. There were opportunity costs associated with the debt crisis: The individuals and companies losing jobs and exports were not always those benefiting from U.S. growth;[3] unemployment might have been lower and growth higher in Europe if demand had been stronger in developing countries. Nevertheless, the economic reversal in the Third World was not as sharply felt in the industrial countries in this decade as it might have been had the U.S. economy grown more slowly and pulled in fewer imports.

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[3] Statistics published by the U.S. Bureau of Labor, for example, show a net reduction in manufacturing sector jobs from June 1981 through June 1988, alongside substantial gains in most other sectors over the same period. (See Employment, Hours and Earnings: U.S. 1901-84, Volumes I and II, March 1985, Bulletin 1312-12 and The Employment Situation: June 1988, July 1988, Table B-1.)

It was U.S. demand, of course, that helped some developing countries generate the large surpluses that enabled them to service their debts despite sharply diminished capital inflows. While most of these trade surpluses were a consequence of sharply curtailed imports, Latin America has increased exports to the U.S. while exports to Europe and Japan in the period 1985-87 dropped.

This could all change as the U.S. comes to grips with its own debt problem. A reduction in U.S. demand will almost certainly be necessary to shrink its trade and payments deficit, and unless this is offset by a corresponding rise in European and Japanese demand--an uncertain prospect--developing countries will find it more difficult to maintain the level of exports necessary to service their debt. At the same time, Third World markets will become more important for industrial countries: Increased demand for imports by developing countries can be a much needed stimulus to global growth. But Brazil, Mexico, the Philippines, et al. cannot act even as a small "locomotive" until their debt problem is eased. The economic self-interest of the developed countries is therefore to be counted among the compelling reasons for seeking more rapid progress on the debt front.

PART I

THIRD WORLD DEBT MANAGEMENT IN 1988

International debt negotiations have been proceeding with varying degrees of success. The major debtors and their banks continue to come to the negotiating table; hundreds of billions of dollars in loans have been rescheduled; interest rates and fees have been reduced; new loans have been extended and the biggest debtors continue to make efforts to stay current on interest payments. Several smaller debtor countries, on the other hand, have received no new loans, nor are they paying off old ones. At the same time, debtor country governments are now acknowledging the need for the sort of structural economic reforms long demanded by creditors, and some have begun to curtail government spending and raise revenues, to eliminate unprofitable state enterprises and liberalize trade and investment, and to maintain market-supported exchange rates. Moreover, the banking system is stronger now than in 1982 as a result of generally higher levels of capital and reserves.

After a decade of severe economic contraction in the Third World, during which development as measured by the quality of life for vast numbers of people has been halted and even reversed, there are some signs of recovery. World Bank figures show that eight of the 15 largest troubled debtor economies grew by 4-5 percent in 1987. Chile and Brazil have had several years of substantial growth, although in Brazil this is accompanied by hyperinflation. Imports by Latin America, which fell by more than a third after 1982, have begun to recover. U.S. exports to the region last year reached their pre-crash, nominal level (but still below 1981 in real terms). And several countries, including Brazil, Chile, and Mexico, have had significant export gains in the last two years, boosted in part by product diversification, in part by higher commodity prices. An innovative financing package for Brazil has been agreed to in principle. The package will help that country become current on overdue interest payments and meet interest payments in 1988 and 1989. The package also includes some significant debt-reduction features.

Despite these achievements, six years into the debt crisis the goal of "normalizing" relations between debtor countries and the banks has yet to be reached. In the eyes of the financial markets, nearly all the countries that have rescheduled their debt since 1982 remain uncreditworthy. Restiveness and frustration with the lack of clear progress across a broad front is apparent on both sides.

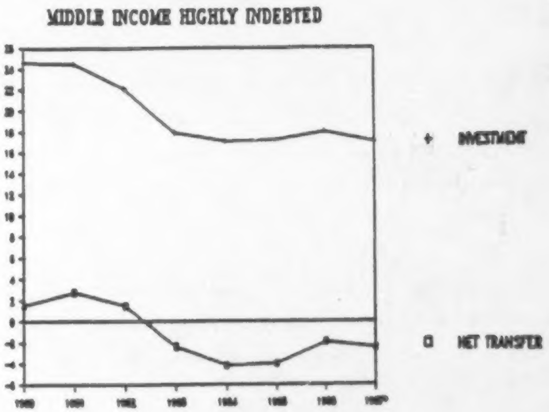
The banking community shows signs of being divided over tactics and strategy, and many smaller and medium-sized banks are no longer actively participating in new money packages.

Many troubled debtor countries continue to operate under a severe resource constraint, making it difficult to service a large foreign debt and, at the same time, sustain the sort of noninflationary growth that will raise the level of domestic consumption and stimulate investment.

Particularly worrisome for the long-term economic outlook of these countries is the low level of investment since 1982. As the Bank for International Settlements (BIS) points out in its 1988 annual report, "several years of low investment growth have adversely affected output capacities and potential output growth. This was seen early last year when a recovery of domestic demand growth in several Latin American countries quickly encountered bottlenecks and led to inflationary pressures, even though per capita incomes were still well below earlier levels. Moreover, lower potential output growth narrows the scope for improving the external balance in the longer run--without reducing the level of domestic absorption--and for raising per capita income levels." In other words, debt servicing capacity depends on expanding total output. Annual investment levels in Latin America in the 1980s have fallen to 15-17 percent of GDP, well below the 25 percent or so that prevailed in the 1970s and below the level needed to sustain a minimum growth rate of 4-6 percent.

A number of factors combined to produce this sharp drop in investment. Clearly an important contributor to the decline in domestic investment is the size of the net transfer of resources abroad (total debt servicing outflows less credit inflows from all sources) associated with a country's debt servicing [see Chart].

Net resource transfers and investment in middle-income countries
(Per cent of GDP)



Source: Barry Herman, Department of International and Economic and

It is possible that in some debtor countries, continued domestic economic reforms and strong political leadership alone will lead to economic recovery in the near future, provided recent levels of negotiated credit flows are maintained. Brazil, Uruguay, and Chile are most often mentioned in this context, but members of the panel differ as to which troubled debtors have this potential. Much depends upon the domestic policies followed by each country.

In many more cases, a permanent solution to the debt problem and full economic recovery will require both domestic reforms and a reduction of the resource gap. This resource gap is unlikely to be bridged by the current level of new lending. But a significant increase in credit flows is unlikely, given current market conditions and the current public policy and regulatory environment.

PART II

FIRST PRINCIPLES

Over its six months of discussion, the EPC panel concluded that certain general conditions were essential to solve the debt problem. These are summarized here as a set of "first principles":

- Progress on the debt problem requires strong and active leadership by the governments of the major industrial countries and by the official multilateral institutions whose policies they largely set.

- Debtor countries must accept that the outside world cannot solve the debt problem for them. External relief, whether in the form of more credit or debt-service reduction, will not lead to sustained noninflationary growth and development unless the debtors themselves undertake major internal structural reforms.

- The gap between debt-servicing outflows and financial inflows from all sources may be so large as to impede sustained economic growth by a debtor country, even one that has enacted effective economic reforms. Indeed, the financing gap may be a serious obstacle to structural reforms in weakened economies. In these cases, additional measures must be taken by creditors, official and private, to help close the resource gap.

[*] Debt-service reduction should be considered as an alternative to increased borrowing as a means of closing the resource gap. In most cases, some combination of debt reduction and new money will be required to solve the debt problem.

PART III

CREATING THE RIGHT CONDITIONS

The principal parties--the debtor countries and creditor banks--are receptive to, indeed are seeking, new approaches to the debt problem. But it is difficult for a disparate group of debtors, which face different economic and political constraints, and hundreds of banks from many different countries, which operate under different regulatory regimes and with different strategies and competitive capacities, to agree on alternatives.

Some of the most promising approaches described later in this report involve changes in the terms of existing loan contracts. This raises complex legal and regulatory issues that cut across national borders. Governments in the major financial centers, acting in concert, can help resolve such matters. In fact, many of the issues that arise between commercial lenders and debtor governments--conditionality, maturity and interest rate structures, security--also arise in the sovereign-to-sovereign debt negotiations of the Paris Club. And since the policies and decisions of the multinational agencies are the responsibility of the executive directors appointed by the sovereign members of those agencies, there is no escaping the role that governments must take in this part of the process. Acceptance of that responsibility has been slow and inconsistent.

Fundamental policy reforms in the debtor countries are also an essential condition for further progress on the debt problem. There can be no permanent solution to current economic difficulties without budget and tax reforms, a reduction in public sector deficits, and policies to promote export growth.

Internal resources have always provided the bulk of the financing for growth and development, even in the heyday of cross-border lending in the 1970s. Economic recovery and sustained growth are possible only when domestic savings are mobilized and domestic investment stimulated. Scarce financial resources will be used most efficiently when the role of public enterprises is reduced and public policy fosters economic expansion through a dynamic and competitive private sector. The financial sector is perhaps most critically in need of reform and liberalization in many debtor countries. Savings will not increase or be productively employed without well-functioning domestic financial markets and institutions.

Economic success over time also requires a level of public confidence that grows out of effective, uncorrupt leadership and a political system that is responsive to the popular will.

PART IV

EASING THE RESOURCE CONSTRAINT ON DEBTOR COUNTRIES

The question of how to ease the continuing shortfall in resources among heavily indebted countries that are undertaking adjustments became the focus of the debt panel's liveliest and most extensive discussions. The panel considered ways to increase the flow of capital into troubled debtor countries and alternative means of easing the resource constraint on these economies. The remainder of this report sums up the group's findings and conclusions on this point.

There are two basic ways to eliminate the debt-related resource constraint over the short run: have more money coming into the country relative to what goes out, or reduce absolutely the amount of money that goes out. The Baker Initiative[4] posited the first approach--an increase in official and commercial lending combined with debtor policies to attract foreign investment and flight capital. Since then, more money has flowed to a number of countries; Brazil, with its recent new money agreement, is one example.

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[4] On October 8, 1985, then U.S. Treasury Secretary James Baker proposed a three-part strategy for dealing with Third World debt: adoption by debtor countries of growth-oriented domestic economic reforms; a three-year $9 billion increase in lending by the World Bank; and commercial bank agreement to a three-year $20 billion increase in net new lending.

But the resource gap was manageable for debtors primarily because debt-servicing costs declined between 1985 and the end of 1987. In this period, dollar interest rates fell, principal was rescheduled, and commercial lenders accepted lower spreads on new and on rescheduled loans. A few countries have recently been able to reduce their absolute debt burden through debt-equity swaps and other debt-transforming transactions.

Although some new money is flowing, net lending by both official institutions and private banks has declined since 1984. Owing to amortization and interest and dividend payments to foreign lenders and investors, the net negative transfer of developing country resources to the rest of the world has been more than $20 billion dollars per year since 1985.

Further relief on the interest front seems unlikely. As noted, interest rates have already started to climb in 1988 and are likely to rise still more in the next 12-18 months. There is strong market resistance to any across-the-board lowering of spreads below the 13/16ths included in Mexico and Brazil's multiyear restructuring agreements. Any further easing of the debt-servicing burden will have to come through other means.

New Money

The "new-money" solution involves the provision of more net lending than in the last few years to make it possible for debtor countries to service their debts and, simultaneously, grow more rapidly. The net resource relief provided would be the amount of additional new lending less the interest costs of the new loans.

Covering the resource gap with new loans has a number of advantages. It permits the debtor countries to continue to meet their contractual obligations, thereby avoiding losses to existing creditors and preserving their "good name" in the market. And it gives creditors continued leverage over the debtor: New loans can be disbursed in installments or " tranches" and made conditional on policy reforms and certain performance targets or (to the extent the money is not all absorbed by interest payments) targeted on specific projects that maximize returns.

The new-money approach can also have drawbacks for some countries. There is generally a lag between the increase in indebtedness and the time the investments the debt finances generate returns that can be used to reduce the debt. In the meantime, since new borrowing gives rise to additional debt-servicing costs, the flow of foreign exchange will have to grow each year to provide a constant net amount of cash flow relief. More debt also means that for a time, most debtors are more vulnerable to a slowing of the world economy or higher interest rates. Countries that already have an extremely high level of debt relative to GNP might find that taking on more debt further undermines confidence in their economic viability.

Substantial new commercial financing is increasingly hard to come by, even for countries that could carry a greater debt load. Many smaller banks are opting out of Third World lending altogether, making the "free rider"[5] problem acute in a new-money strategy. Many smaller banks were marginal participants in the international markets to begin with, and some mid-sized banks, having had second thoughts about going international, can no longer be pressured to make new loans. Recent restructurings offer these banks "exit bonds" as a substitute for putting up new money, which, as in the recent Brazil deal, have the dual benefit of reducing the need for new money and converting some debt servicing into local currency. (Certain banks are exchanging part of their loan portfolio for such bonds as well as putting up some new money.)

Even the big banks that remain committed to international lending in principle seek to reduce their LDC exposure overall, and not just relative to capital and total assets. Citibank, for example, while continuing to participate in new-money packages, has said that it intends

to reduce its dollar-denominated exposure to troubled LDC debtors by $5 billion, or more than 30 percent, over five years.

Banks are understandably reluctant to add new assets that are immediately deeply discounted in the secondary market. The secondary market is thin and not fully indicative of the value of banks' loans, Brazil's debt, for example, was selling for 50 cents on the dollar at the end of June 1988 when the Brazilian agreement was initialed. Large additions to loan-loss reserves last year leave many banks better able to sell loans and take losses. At a minimum, the banks want to have the option of holding loans or selling them without excessive discounts. Consequently, a broad market for LDC loans is important to many banks.

There has also been a recent marked shift in the banking community's strategic interests. Money-center banks are marshalling resources to meet heightened competition and new opportunities in the recently liberalized financial markets of the industrial countries. Nationwide banking and the elimination of many barriers between investment and commercial finance are imminent in the United States. Europe and Japan are giving foreign banks unprecedented entree to their previously highly restricted financial markets. The European Community has pledged to dismantle all controls on capital flows and permit pan-European lending among member countries by the early 1990s. Tying up capital to back LDC loans may inhibit expansion into these more attractive markets. Meanwhile, profit margins on restructured Third World loans have shrunk considerably, the risks remain high, and the attraction of pursuing business in the industrial countries, and in the successful Pacific Basin countries, increases.

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[5] The term "free rider" is used to refer to banks that benefit from debt solutions without contributing to them.

The commercial bank situation has also been influenced by a recent revolution in regulation. British, American, Japanese, and other regulators are implementing a joint agreement to impose uniform "risk-weighted" capital adequacy requirements that not only tighten the definition of capital but also include many off-balance sheet items in the denominator. The new requirements will be phased in until 1992. Only a few of the U.S. money-center banks, which hold most of the Third World exposure in this country, can meet these new standards today. Others will have to shrink the balance sheet or raise substantial new equity capital. A large block of problem loans to debtor countries makes raising capital difficult and expensive: The new regulations create incentives for banks to reduce the balance sheet generally and specifically to reduce outstanding loans to troubled debtor countries that the regulators weigh as a high risk under the new guidelines.

For U.S. banks, the capital situation is further complicated by last year's large additions to general loan-loss reserves against troubled Third World loans. Some

of these reserves came out of equity but under the old rules were still considered primary capital for capital-adequacy purposes. Only a small part of these reserves will count as primary capital after 1992, and then only as "Tier 2" capital.[6]

Recent changes in tax and accounting rules also affect U.S. banks' cost/benefit analysis of carrying LDC loans. The 1986 tax reform limits the use, after 1990, of large foreign tax credits generated by LDC loans to reduce U.S. corporate income tax on foreign-source income. Before the 1986 law, banks could allocate a certain amount of income to loan-loss reserves on a pretax basis, but under the new law, banks will gradually have to recapture unused portions of these reserves into taxable income. Further, beginning in 1989, revised accounting standards will limit the ability of banks to report anticipated tax benefits on their income statements before tax losses are actually realized. Before this rule changed, banks could anticipate loan losses and take the projected resulting tax recovery into current income.[7]

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[6] Banks will have to have Tier 1 capital equal to 4 percent of total risk-weighted assets, and Tier 2 capital equal to 4 percent of assets. Only common shareholder equity and some classes of preferred stock will count as Tier 1 capital. As of January 1988, only two U.S. money-center banks had equity in excess of 4 percent of assets.

These changes affect banks differently, depending on their relative loan exposure, capital base, and mix of domestic and international earnings. These differing effects may in turn explain disagreements in the banking community over how to proceed in managing the international debt problem. Taken together, the regulatory, tax, and accounting changes probably make holding LDC assets to maturity less attractive for many banks.

More credit may be the optimum solution for many debtor countries, but the reality is that public policy and market conditions create a strong disincentive to lend to problem LDCs and a strong incentive to reduce what exposure one has.

Banks would be less reluctant to participate in large-scale, medium-term lending if there were some official enhancement of the new assets--guarantees, cross-default, co-financing packages, etc. Direct linkage of new

commercial bank loans to official loans or guarantees would reduce the risk of future default, enhance the value of the new asset in the eyes of investors, and perhaps provide banks with greater leverage over the debtors. Tight linkage might also reduce the charge against capital that new loans would carry.

Multilateral institutions have accepted the idea of closely relating official disbursements of official monies with commercial loan disbursements. Commercial loan disbursements have been made conditional on certain monies flowing from the World Bank, for example--most recently in the new financing package for Brazil. But official lenders have resisted the reverse linkage of making official loans conditional on a certain performance by the borrower vis-à-vis commercial lenders. Their reluctance is understandable. These official institutions have a different mission from that of commercial banks. A cross-default provision with commercial lenders, for example, could halt vital World Bank development projects when a developing country is having a dispute with its commercial lenders. And with a membership that includes many debtor countries, multilateral institutions must consider politics as well as economics.

Perhaps the strongest objections to close official-commercial linkage on new lending stems from a widely held perception, particularly in the U.S. Congress, that the primary beneficiaries are the banks and not the debtors. Close linkage raises "important questions about whether public money is being put at risk in an effort to minimize the risk and the losses suffered by private commercial banks," as Congressman Bruce Morrison put it to Treasury Secretary James Baker at a hearing on the World Bank General Capital Increase (GCI).

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[7] The IRS does not recognize general loan-loss reserves and grants tax deductions only for losses actually taken, i.e., loan write-offs. But current accounting practice allows banks to claim these future tax benefits before actual losses, based on loan-loss reserves, when making income statements to shareholders. After December 15, 1988, it will no longer be accepted accounting practice to boost reported earnings through this device. See Financial Accounting Standards Board Statement No. 96.

The panel does not wish to recommend specific linkages, but it concludes that further development of co-financing and parallel financing is desirable. Further, the panel feels it is imperative that official lenders add more resources. The GCI for the World Bank should enable that institution to increase significantly its level of lending to troubled debtors. When this report was signed, the United States Congress had not yet approved the U.S. participation. The panel very strongly urges it to do so. The multilaterals should also have the flexibility to modify rules that restrict unnecessarily members' access to official funds. Finally, the panel urges the Administration to negotiate a speedy end to the differences that are holding up the general capital increase at the Inter-American Development Bank and inhibiting its ability to play a larger role in financing Latin American development.

Debt Service Reduction

An alternative--or a complement--to increasing the flow of money to debtor countries is to reduce the outflow of debt-servicing payments. This can be accomplished by a reduction in principal, a reduction in interest charges, or both.

The panel believes that a voluntary, negotiated debt-service reduction through restructuring of debt or an exchange of debt for another financial asset can be a constructive approach to the resource constraint of some troubled debtors. Indeed, it may be the only viable solution for many smaller debtors. It can also be an effective technique for easing the financial strains of larger debtors.

Debt-service reduction could have significant benefits for creditor banks as well, if the asset transformation or exchange enhances the quality of their loan portfolios.

In a debt-for-debt exchange, banks would exchange old loans for new debt at a discount. Some banks may prefer an asset swap that reduces principal but maintains or increases interest income. Others may prefer to take new debt with the same face value but to assign smaller interest payments. Both involve losses for the banks: The former involves a loss at the exchange; the latter spreads the loss over time. The panel agrees that debt exchanges that include one or both features offer advantages for both banks and the debtor untries. The discount represents debt the country no ager has to service, debt the banks no longer have to nance, and assets the banks no longer have to charge ainst capital.

Debt-service reduction can increase the resources ailable for investment and consumption in debtor countries thout increasing foreign claims on the country's future oduction, and without increasing its vulnerability to a se in interest rates, for example. A one-time reduction debt provides permanent resource relief for the debtor onomy. And less reliance on new borrowing, it could be gued, should increase the likelihood that a country will ow out of its debt problem. Furthermore, the appearance a stable or a shrinking foreign debt should also have ychological benefits, eliminating the uncertainty that pedes long-range economic planning and discourages ivestment.

Banks would no longer be faced with a continuous emand for new loans. The effect of reducing the troubled ans on their books would be to stabilize their risk rofile, enhancing share price and thus improving their bility to comply with new capital requirements and manage heir strategic direction.

Strong government support and direct participation in ebt swaps is critical for maximizing their effectiveness as tool for solving the debt problem. Debt-servicing

reduction is already being carried out without official creditor-country backing, as in the case of debt/equity swaps and the Mexican long-term bond exchange. But the impact on the debt problem has so far been modest, except in Chile and with regard to the Mexican private sector debt. Recently, significant transactions have also taken place in Brazilian public and private sector obligations. Official support and participation in debt-reduction programs would encourage much wider use, increase the discounts that banks are willing to grant in debt exchanges, and reduce the cost of swap instruments to the debtor. Official support for transactions involving commercial bank debt is defensible on these terms because the "burden sharing" is obvious.

As an incentive for discounting old debt, banks will want the new claim to carry some sort of enhancement--more security, more income, or both. What makes such transactions attractive is that the banks get a new, higher-quality asset in return for taking a loss in reducing their claim. Without some sort of guarantee, banks might have to give up a second large discount--this one to the buyer and without benefit to the debtor--when they try to sell the new asset. With some form of official backing, banks will get a secure asset that they can sell or hold on the books without penalty. Under the new regulations, an officially backed asset would also carry a lower charge against capital.

It has been suggested that official entities buy outright all commercial bank claims on the public sector in troubled debtor countries--in effect offering a full official guarantee for principal and interest, less discount. The panel believes such a buy-up of the debt, even at a discount, would be unnecessary, overly expensive, and too cumbersome to negotiate on the global scale contemplated in various proposals.

More limited government participation and commitment of funds could be just as effective in encouraging debt service reductions while preserving the essential relationship between banks and debtors. Partial official guarantees on the new debt issued by the debtor to the creditor banks could have a major catalytic effect on such transactions. The guarantees could cover several years' interest, for example, or part of principal, or a little of both. (It is the security of the income stream that largely determines the market value of a long-term asset, so that partial official guarantees on interest would be particularly useful.)

The guarantees could be provided bilaterally by governments or residually through the multilateral lending institutions, say, by the World Bank and the IMF acting separately or together. (Closer coordination between these institutions on the debt issue is highly desirable, in any event.) The role of guarantor would be fully consistent

with the World Bank's mission to support economic reconstruction and development and with the IMF's responsibilities for stabilizing the international financial system. One would look to the industrial countries with large balance of payments surpluses to be particularly forthcoming. Japan has long indicated a willingness to commit substantial sums to help Third World countries but has been criticized for failing to put forward concrete proposals and programs. At the Toronto seven-nation Economic Summit in June 1988, Japan reportedly made a general proposal for some official backing for discounted asset exchanges between debtors and creditor banks that would appear to merit serious consideration.

Official support is also vital with regard to the regulatory treatment of old and new bank assets involved in debt-alleviation programs. A voluntary approach is desirable, and any debt-reduction scheme is more likely to be accepted by banks if the plan does not leave one group of banks with a competitive advantage over another. Different regulatory approaches among national regulators are not an insurmountable obstacle to innovative solutions but can make negotiations more complex, and there must be reasonable compatibility and consistency among supervisors. Areas of particular concern are treatment of reduced or capitalized interest, classification of swapped assets, and loan-loss reserve requirements. Where possible, harmonization of tax treatment of reserves and losses incurred by banks should be sought through legislation.

Finally, official cooperation may well be needed to deal with the problem of "free riders"--banks that benefit from debt solutions without contributing to them. The problem is a delicate one, but toleration of free riders makes a coherent approach to the international debt problem increasingly difficult.

Banks in an international loan syndicate have contractual rights not only vis-à-vis the borrower but with other syndicate members as well--the most important in this context being the right to share on a pro rata basis in any payments made by the debtor to the syndicates. The sharing clause makes it difficult to deny interest payments to a bank that, say, refuses to participate in new lending even as the new loans from other banks are financing those payments.

The free rider problem may be more manageable in debt service reduction schemes, where discounted asset exchanges are a substitute for a new money package for all banks in the transaction. It may also be more manageable when debt service reduction serves as a complement to new money packages. In those rare instances when a bank might persist in pressing its original claim, regulatory and other governmental actions might also be taken to encourage a "free rider" to accept the new arrangement.

There is some concern that debt service reduction might discourage future lending if potential lenders or investors consider it more important that a country failed to live up to past obligations than that it now has less debt. However, the panel points out that there is a considerable difference between a unilateral moratorium or repudiation and a voluntary, negotiated, contractual debt swap that is mutually accepted by creditor and debtor.

Debt Service Reduction: The Problems of Adjustment and Leverage

Two issues are often raised with regard to structural adjustments by the debtor countries in the context of debt reduction schemes. When banks lend more money, they take on additional risks, but they also stand to gain from the debtor's eventual recovery. In a debt service-reduction transaction, the rewards for participating are reduced exposure, reduced capital commitments, and reduced demand for risky new credits. Banks might make even larger concessions if they also stood to benefit from a debtor's eventual recovery after a discounted debt exchange. (Taking back concessions is not feasible.) An exchange that includes the equivalent of a warrant giving creditors the right to acquire an equity position in certain classes of enterprises or some other right to claim a share of a country's future economic growth might be an added inducement for banks to accept debt service-reduction plans.

The panel agrees that debt service reduction raises the general problem of moral hazard--specifically, that some countries might ask for debt reduction when continued internal policy adjustment might be sufficient to allow them to return to the voluntary credit markets in the not-too-distant future. As noted, panel members disagree about which countries currently need debt alleviation and which do not. The official guarantor would have to make a judgment about the size of the discount the country requires and condition the issuance of guarantees accordingly. As long as such programs are voluntary, banks can decide which claims they will discount, and by how much, and which they prefer to hold at full value.

Banks and official lenders will insist that debtor countries continue to make internal adjustments. Credit denial is the most direct leverage available to lenders, and there is concern that this leverage is lost in debt-reduction schemes. Once taken, debt-alleviation measures cannot be reversed, but a debt service-reduction program could be "tranched"--making increasing amounts of

debt eligible for official guarantees as the debtor shows it is carrying out reforms--to permit the official guarantor to exercise conditionality.

Conditionality is always difficult to enforce where a sovereign state is concerned. The best response to bankers' concerns about loss of leverage is that debt reduction, even if substantial, will not obviate most debtor countries' need for commerical trade credits, foreign investments, or access to official development loans, which can still be made conditional on sensible policies. And ultimately, while outside pressure may help sell difficult adjustments at home, sovereign states will pursue correct policies because they perceive these policies to be in their national interest and not because they were imposed from the outside.

Finally, the panel stresses that other debt-reduction mechanisms of proven effectiveness--for example, the debt/equity conversion programs in place in some countries, the ongoing negotiated exchanges of private sector debt, and well-designed exit bonds--and still other programs now being explored and pursued--for example, those to finance trade and environmental projects--should be encouraged. These programs represent increasingly important investments in the less-developed countries and, together with the debt service reductions discussed here, will accelerate the reduction of external debt and, consequently, economic growth in debtor countries.

Interest Capitalization and Payment in Local Currency

The panel considered several alternatives to negotiated new-money packages or debt reduction, including interest capitalization and payment of interest in domestic currency that stays in the country. These are similar to new loans in that they increase the outstanding indebtedness of the debtor and the loan exposure of the banks but have the advantage of avoiding the costs and delays of raising new loans.

These techniques introduce a certain automaticity, since they can be repeated once banks and debtors agree upon how much interest will be treated this way and for how long. Interest capitalization is considered an alternative where regulations permit banks to deduct the sum from taxable income and do not count capitalized interest as new exposure requiring additional reserves. But under current U.S. practice, capitalization would likely be grounds for placing a loan on a nonaccrual[8] basis. Regulatory treatment of interest paid in local currency is uncertain.

These financing techniques also raise the issue of "moral hazard." Once a country is allowed to capitalize a certain percentage of interest due or to pay in local currency, it might be inclined to insist that all its

interest be treated this way for an indefinite period of time. While some proponents argue that such concessions would be reversible down the road, many bankers are skeptical. The incentive to continue internal reforms might also be diminished once the need to attract large new balance of payments loans is no longer acute.

The panel thinks that in most instances, debt service reduction would be more acceptable than interest capitalization.

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[8] Generally, when a loan is classified as nonaccruing, payments by the debtor cannot be included in a bank's current income statements until arrears are reduced to zero.

PART V

CONCLUSIONS AND RECOMMENDATIONS

1. We urge the governments of the major financial centers to exert strong leadership on the debt issue and to move decisively to forge a consensus among the key players on a set of approaches that not only preserves a stable banking system but allows the debtor countries to resume stable growth and economic development benefiting all their people. Current policy has so far failed to achieve the second of these goals in most cases.

Strong official leadership is necessary, not to substitute public funds for private credit, public risk for private risk, but to restore a sound and sustainable credit relationship between debtor countries and the international financial markets. There are vital economic and political, as well as financial, issues at stake.

Banks and debtors are open to new approaches to the debt problem. But the industrial countries and, to a degree, the official multilateral institutions as well have sometimes failed to encourage--indeed, on occasion, have resisted--the trend toward flexibility and the search for innovative solutions to the debt problem.

2. The panel strongly supports the emphasis given by creditor governments, official institutions, and banks to the need for structural reforms in debtor countries. Virtually all suggested debt plans require that debtor countries reform various segments of their national economies. There was no serious disagreement among panel members on this point: Domestic reforms are the key to sustained economic recovery for even the most troubled debtor countries.

Any easing of the debt burden by external measures without parallel domestic efforts will yield only temporary relief: The additional resources freed up for domestic use are likely to be squandered or redeployed abroad through capital flight, eventually resulting in a new debt crisis.

3. The panel recognizes that the current gap between debt servicing outflows and financial inflows from all sources--commercial banks, official lenders, and direct investors--may be too great for some debtor countries to bridge even with effective economic reforms. And indeed, heavy external debt servicing requirements may create conflicting economic and political pressures that make the adoption of fundamental reforms extremely difficult--or, if undertaken, can overwhelm the potential benefits. Under these circumstances, creditor banks and governments must act in concert to help close the gap.

4. The panel very strongly urges the U.S. Congress to approve the U.S. contribution to the World Bank's General Capital Increase and encourages expanded and more imaginative use of co-financing and parallel financing techniques by the World Bank and regional development banks to catalyze the aggregate flow of new funds.

5. For the reasons outlined in the report, large new lending programs may be difficult to secure under current market conditions. The panel believes that voluntary debt service reduction should be pursued as a serious alternative or complement to more lending. It may be the only alternative for many smaller debtors that have already been written off by the banks. But this approach, alone or in combination with other measures, may also be an effective technique for easing the financial constraints on larger debtors.

Despite the losses entailed, debt service-reduction transactions can have considerable benefits for creditor banks as well, if the asset transformation or exchange enhances the quality of their loan portfolios.

Debt service-reduction schemes should be supported by creditor governments, bilaterally or multilaterally. Although the panel thinks a government buy-up of sovereign commercial debt is neither necessary nor desirable, it believes that government support for debt service-reduction

transactions between debtors and commercial lenders can be catalytic. Official backing, perhaps including partial official guarantees, would lead to much wider use of this approach and would enhance its effectiveness as a tool for solving the debt problem. Governments also need to implement more compatible and consistent supervisory rules to facilitate a resolution of the debt situation.

6. Concerns have been raised that debt service reduction in any form would discourage future lending. On the contrary, most panel members believe: If debt service reduction is carried out cooperatively and voluntarily through negotiation and mutual agreement by the principal parties, and has the desired effect not only of reducing outstanding claims against the country but of aiding economic recovery, then "credit-worthiness" will come sooner rather than later.

RESERVATION

While we generally agree with most of the specific points in the report, we feel it tends to underestimate the achievements, flexibility and innovativeness of the cooperative, case-by-case strategy being followed in managing the crisis.

Progress has certainly been slower than many of us had hoped. Yet the commercial banks have generally been meeting the financing needs of restructuring countries with viable economic programs. Several countries, such as Chile and Uruguay, are adjusting their economies and growth is gradually being restored. Mexico also is making a strong effort to promote exports, bring inflation under control—even at a cost to current output—and lay the basis for sustained growth in the future. Brazil has adopted basic reforms and its current program underscores the prevailing view that a cooperative approach is in the restructuring countries' best interests.

Various debt-reduction measures recommended in the report are already important options on the menus being agreed between the banks and the countries. These measures evolved significantly in the current Brazil package, which was being negotiated while our panel deliberated. For the first time, the agreement with Brazil combines major debt-reduction options with new money. New ideas will continue to arise, reflecting changing conditions, and be tested against the common goal of helping the countries regain access to the voluntary capital markets.

We agree with the recommendation that creditor governments should show greater leadership. We believe these governments can contribute most productively by continuing growth-oriented, low inflation macroeconomic policies and by avoiding protectionism; through more flexible Paris Club reschedulings and through credit enhancements (World Bank co-financings and B-loans, for example) where appropriate.

Growth-oriented policies in the debtor countries require vigorous private investment programs. There are two sides to this equation: one is the importance of initiatives which encourage local investment—and so help to attract the return of flight capital—and the other is the equally vital need to attract more foreign investment, through well-conceived and aggressively-managed programs.

The importance, moreover, of structural adjustment within the countries is a specific recommendation in the report with which we agree most strongly. This is the prerequisite for the stable, sustained growth that ultimately is the only way to bring the countries, one by one, out of the debt crisis.

William R. Rhodes
Group Executive and
Chairman, Restructuring Committee
Citicorp/Citibank

Robert Carswell
Senior Partner
Shearman & Sterling

DISSENT

While the Economic Policy Council report contains several commendable points, we cannot endorse the document, since in our view its overall substance and tone does not adequately reflect the considerable progress achieved to date in the cooperative, case-by-case restructuring process, nor the success of many countries in their own economic adjustment programs.

We have long maintained that no panacea exists for a resolution to the difficulties of refinancing countries, but that each country should be accorded a unique program which addresses its unique requirements. Furthermore, because this process is evolutionary, many innovative options have been adopted within the context of the current approach. Good examples are the Chilean Amendments recently signed and the current Brazil package which combines new money, an IMF Adjustment Program, substantial debt reduction and interest reduction measures through exit bonds. Through voluntary market based programs, Chile has reduced its medium term debt to financial institutions by 28 percent, while Brazil and Mexico have made substantial progress in reducing their commercial bank debt.

Although we agree with the report's conclusion that debt service reduction programs should remain voluntary, we feel that, in many instances, their broad application, even on a cooperative and negotiated basis, could very well hinder the flow of funds necessary to keep these countries on the road toward sustained economic growth.

Susan Segal
Senior Vice President
Manufacturers Hanover Trust Company

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SEPTEMBER 1988

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Senator SARBANES. Thank you, Mr. Wagner. Mr. Botero.

STATEMENT OF RODRIGO BOTERO, CO-VICE CHAIRMAN, INTER-AMERICAN DIALOGUE AND VISITING SCHOLAR, CENTER FOR INTERNATIONAL AFFAIRS, HARVARD UNIVERSITY, FORMER MINISTER OF FINANCE, COLOMBIA

Mr. BOTERO. Thank you, Mr. Chairman. These hearings on Latin America's debt reflect a considerable attention on the part of the subcommittee to an issue which will have decisive influence on hemispheric relations in the immediate future. I appreciate your invitation to testify again on this matter. You have my written testimony which will, I understand, become part of the formal record. I will here summarize my main points.

Today's hearings take place at an especially opportune time. Leaders of eight Latin American countries have called for a summit meeting with the heads of government of the industrialized democracies. The new Presidents of Mexico and Venezuela have made the question of debt reduction a high priority item on their respective national agendas. On the part of the creditor countries as well as the commercial banks, there are signs of greater willingness to explore new initiatives to alleviate the developing country debt burden. And last, but surely not least, the new administration in Washington has announced that it will take a fresh look at Latin America's debt problem.

In this reappraisal the new Secretary of State, Mr. James Baker, will be in a position to make an invaluable contribution, given his experience at the Treasury and the constructive role he has played at earlier stages of the debt crisis. I am also sure that Vice President Quayle has returned from his meetings with the hemispheric leaders in Caracas with a new awareness and sense of urgency.

DECLINING ECONOMIES OF LATIN AMERICA AND THE CARIBBEAN

The economies of Latin America and the Caribbean have declined further in the past 6 months. Overall, in 1988, the region suffered a 1.5 percent drop in per capita income. This reduction, combined with earlier losses, left output per person in the region 7 percent lower than in 1980 or about at the same level that it had reached in 1978. This disappointing growth performance was accompanied by an unprecedented increase in the rate of inflation. Regionwide, consumer prices for 1988 increased by 472 percent, a historical record. This figure is heavily influenced by cases of Brazil, Argentina, and Peru. In the case of Peru, the country is approaching hyperinflation, and in the case of Brazil, it is close to that level.

The persistence of the debt overhang is a major obstacle to economic recovery in several of the heavily indebted Latin American countries. The problem facing a heavily indebted country can be illustrated with the following example:

Suppose there is a developing country with a GNP of 100 units and total external debt of 50 units, on which an interest of 10 percent per year must be paid. The interest payments alone would amount to 5 units per year, that is, the equivalent of 5 percent of the country's GNP. If the domestic savings rate is 20 units per year, then one-quarter of the domestic savings must be used to service the debt, leaving only 15 units for investment. An investment rate of 15 percent of GNP is insufficient to bring about adequate growth in a developing country. The desired rate is normally 20 to 25 percent of GNP. Therefore, the country in question will not be able to grow out of its debt problem as long as it sends abroad 5 percent of its GNP every year to service a foreign debt.

This is schematically the situation of a typically heavily indebted Latin American country. When such a situation has been reached, the restoration of economic health requires an alleviation of the debt burden, and this implies that a new international strategy for dealing with Latin America's debt problem is needed. The current debt strategy, which was laid out in 1985 by Secretary James Baker, is simply not working. The central premise of the Baker plan was an adequate and sustained growth in the debtor countries was needed to resolve the debt crisis. That growth has not materialized in most countries of Latin America and no improvement is yet in sight.

The Baker plan contained the right ingredients for growth—market oriented, export promoting, policy reforms in Latin America, coupled with the stepped-up flows of external capital to the debtor countries. This recipe was never followed, however. Instead of lending more as the Baker plan had urged, the commercial banks cut back. Making a bad situation worse, official financing from the major international financial institutions, the World Bank, the IMF, and the Inter-Development Bank have slowed down as well. This shortage of international capital has frustrated even the most serious programs of economic reform. When private industry is starved of capital, it can hardly serve as an engine of growth. Exports drives have lagged because imports vital for producing tradeable goods were unavailable. Because resources have been scarce, economic reform programs have mostly led to deep and protracted austerity instead of growth.

No one, therefore, should be surprised by the rising political resistance to market-directed reforms.

The Baker principles ought not to be abandoned, rather they should be put into practice. Latin American debtor countries have to gain access to external capital. What should be clear, however, is that the capital will not come in the form of new commercial bank loans. The banks want to reduce further, not to expand, their lending to Latin America.

No debt strategy can work unless it acknowledges this fact.

INTER-AMERICAN DIALOGUE

I want now to return to the recommendations for action put forth by the Inter-American Dialogue. These reflect not only my own views but also those of approximately 70 individuals of varying political perspectives from the United States, Canada, and 16 countries of Latin America and the Caribbean. The Dialogue sets out five priority tasks that must be accomplished to restore a healthy rate of economic growth in Latin America.

The first responsibility is that of Latin America. Debtor governments must generate and safe foreign exchange by promoting exports and increasing the efficiency of domestic industry. Internally, fiscal deficits must be reduced, inflation controlled, the private sector expanded and strengthened and income and wealth more equitably distributed. Resources can no longer be used to subsidize and finance oversized bureaucracies. Regulations and redtape need to be eased, markets allowed to determine most prices and state enterprises shifted to private hands.

Governments throughout Latin America recognize that these kinds of reforms are vital.

Second, the United States must join other industrial countries to help reduce international imbalance.

Third, the international financial institutions must sharply set up their lending to Latin America. This increased lending should be conditioned on debtor governments' adherence to economic reform programs.

Fourth, the debt reduction agreements must be negotiated between individual debtor countries and their commercial bank creditors.

Fifth, the United States and other industrial countries should actively encourage commercial banks to reach debt reduction agreements with Latin American countries.

With few exceptions, Latin American governments want to find a cooperative solution to the debt crisis. They recognize they have little to gain and much to lose from confrontation.

Latin America's two newest Presidents have made this clear. They have called for a reduction in debt payments to a level that is consistent with the imperative of long-term growth. At the same time, they are not calling for debt forgiveness, debt cartels or unilateral moratoriums. What they are asking for is a genuine dialog with creditor countries to work out solutions that are mutually agreeable and beneficial.

[Complete statement of Rodrigo Botero follows:]

Testimony of Rodrigo Botero

Co-Vice Chairman
Inter-American Dialogue

and

Visiting Scholar
Center for International Affairs
Harvard University

before the

Subcommittee on International Finance and Monetary Policy

of the

Committee on Banking, Housing, and Urban Affairs

United States Senate

February 8, 1989
Washington, D.C.

These hearings on Latin America's debt reflect a commendable attention on the part of the subcommittee to an issue which will have decisive influence on hemispheric relations in the immediate future. I appreciate your invitation to testify again on this matter. Although I am testifying in my personal capacity, I will be drawing heavily on the analysis and recommendations put forth in the just-issued report of the Inter-American Dialogue, of which I am co-vice chairman. I strongly recommend that report for your consideration.

Last year's hearings took place while legislation on international trade was under consideration. Thanks to your initiative and support, the Omnibus Trade Bill of 1988 provides the legal authority for the Secretary of the Treasury to commence negotiations to establish an International Debt Management Authority.

Today's hearings take place at an especially opportune time. As the debt crisis moves into its seventh year, economic and social conditions in Latin American continue to deteriorate. The leaders of eight Latin American countries have called for a summit meeting with the heads of government of the industrialized democracies. The new presidents of Mexico and Venezuela have made the question of debt reduction a high priority item on their respective national agendas. On the part of the creditor countries -- as well as the commercial banks -- there are signs

of greater willingness to explore new initiatives to alleviate the developing country debt burden.

And last, but surely not least, the new Administration in Washington has announced that it will take a fresh look at Latin America's debt problem. In this reappraisal, the new Secretary of State, Mr. James Baker, will be in a position to make an invaluable contribution, given his experience at the Treasury and the constructive role he has played at earlier stages of the debt crisis. I am also sure that Vice President Quayle has returned from his meetings with hemispheric leaders in Caracas with a new awareness and a sense of urgency.

The economies of Latin America and the Caribbean have declined further in the past six months. Overall, in 1988, the region suffered a 1.5 percent drop in per capita GNP. This reduction, combined with earlier losses, left output per person in the region seven percent lower than in 1980 -- or about the level of 1978. This disappointing growth performance was accompanied by an unprecedented increase in the rate of inflation. Regionwide consumer prices for 1988 increased by 472 percent, a historical record. This rate, more than double that of 1987, is a weighted average. As such, it was heavily influenced by conditions approaching hyper-inflation in Peru (1,300 percent) and Brazil (800 percent), and by exacerbated inflation in Argentina (nearly 400 percent). These figures reflect serious macro-economic distortions, and illustrate the enormous difficulties confronting policy-makers throughout Latin America. Given the perverse effects of accelerated inflation on income distribution and social stability, price distortions of this magnitude are alarm bells warning of the proximity of economic collapse.

During 1988, the Latin American economy remained severely constrained by a debt burden of $401 billion. The value of regional exports increased to $102 billion, a favorable development, yet only a modest increase of 15 percent with respect to 1980. The value of regional imports was $74 billion, a figure that is 18 percent below that of 1980. This drastic reduction in Latin American purchases from the rest of the world is another manifestation of the economic crisis.

The 1988 trade surplus of $28 billion was more than offset by interest payments abroad. For the seventh consecutive year, net capital inflows were substantially lower than the value of interest and profit payments to the rest of the world. Negative resource transfers amounted in 1988 to $29 billion.

The persistence of the debt overhang is a major obstacle to economic growth in several of the heavily indebted Latin American countries. If a substantial proportion of domestic savings must be used for debt servicing, there cannot be sufficient productive investment to achieve a satisfactory rate of growth or to sustain meaningful programs of economic reform. The problem facing a heavily indebted country can be illustrated with the following example.

Suppose there is a developing country with a GNP of 100 units and a total external debt of 50 units, on which an interest of 10 percent per year must be paid. The interest payments alone would amount to five units per year, which is equivalent to 5 percent of the country's GNP. If the domestic savings rate is 20 units per year, then one quarter of the domestic savings is used up to service the debt, leaving only 15 units for investment. An investment rate of 15 percent of GNP is insufficient to bring about adequate growth in a developing country. (The desired rate is normally 20 to 25 percent of GNP.) Therefore, the country in question will not be able to grow out of its debt problem as long as it sends abroad five percent of its GNP every year to service a foreign debt.

In extremely simplified form, this example describes the situation of a typical heavily-indebted Latin American country. When such a situation has been reached, the restoration of economic health requires an alleviation of the debt burden. And this implies that a new international strategy for dealing with Latin America's debt problems is needed.

The current debt strategy, which was laid out in 1985 by Secretary James Baker, is simply not working. The central premise of the Baker Plan was that adequate and sustained growth in the debtor countries was needed to resolve the debt crisis. Three years later, as I noted above, that growth has not materialized in most countries of Latin America, and no improvement is yet in sight. With inflation now rampant in many countries and investment in Latin America only two-thirds its average level in the 1970s, the prospects for growth over the next several years are dim.

The Baker Plan contained the right ingredients for growth: market-oriented, export-promoting policy reforms in Latin America coupled with stepped-up flows of external capital to the debtor countries. This recipe was never followed, however. Instead of lending more, as Baker had urged, the commercial banks cut back: in 1986, year one of the Baker Plan, net private lending to Latin America was actually negative for the first time. It has increased only modestly since.

Making a bad situation worse, official financing from the major international financial institutions -- the World Bank, the International Monetary Fund (IMF) and the Inter-American Development Bank (IDB) -- has slowed down as well. These institutions are now collecting more in debt service payments from Latin America than they are putting up in new loans. In the three years since the Baker proposal was announced, Latin America exported $80 billion to its creditors. This amount was even greater than during the three previous years.

This shortage of external capital has frustrated even the most serious programs of economic reform. When private industry is starved of capital, it can hardly serve as an engine of growth. Export drives have lagged because imports vital for producing tradable goods were unavailable. Because resources have been scarce, economic reform programs have mostly led to deep and protracted austerity instead of growth. No one, therefore, should be surprised by the rising political resistance to market-directed reforms. They are increasingly associated with unemployment, low wages, industrial bankruptcies, and deteriorating public services -- and are viewed as largely benefitting foreign creditors rather than producing growth at home.

The Baker principles ought not to be abandoned: rather, they should be put into practice. Latin American debtor countries have to gain access to external capital to invest for growth and to implement needed programs of economic reform. What should be clear, however, is that the capital will not come in the form of new commercial bank loans. The banks want to reduce further, not to expand, their lending to Latin America. No debt strategy can work unless it acknowledges this fact.

But if the commercial banks are unwilling to put new resources into Latin America, they must be prevailed upon to take less capital out: that is, they must reduce their debt claims on Latin American countries. Indeed, debt reduction now seems virtually inevitable. The only question is whether it will come about in an orderly, cooperative, and constructive way through negotiations between creditors and debtors -- or whether it will result from the unilateral actions of Latin American governments stretched to their economic and political limits.

I want now to turn to the recommendations put forth by the Inter-American Dialogue. These reflect not only my own views, but also those of approximately 70 individuals of varying political perspectives from the United States, Canada, and 16 countries of Latin America and the Caribbean. The Dialogue sets out five priority tasks that must be accomplished to achieve the objective we all seek -- that is, to restore a healthy rate of economic growth in Latin America.

The first responsibility is that of Latin America. Debtor governments must generate and save foreign exchange by promoting exports, increasing the efficiency of domestic industry, encouraging the return of flight capital, and attracting new foreign investment. Internally, fiscal deficits must be reduced, inflation controlled, the private sector expanded and strengthened, and income and wealth more equitably distributed.

Resources can no longer be used to subsidize and finance oversized bureaucracies; they must be directed to productive investment. Regulations and red tape need to be eased; markets allowed to determine most prices; and state enterprises shifted to private hands. More generally, governments should be doing less to manage economic activities, and more to provide effective public services -- in education, health, transportation, and other areas. Governments throughout Latin America recognize that these kinds of reforms are vital.

Second, the United States must address its own economic problems and join other industrial countries to help reduce international financial imbalances, avoid new increases in world interest rates, open world markets, and sustain world growth. If Latin American countries must undertake severe adjustments in their economies by cutting budget deficits, balancing external accounts, and reducing trade barriers, so must the United States.

Third, the international financial institutions must sharply step up their lending to Latin America. The IMF and the World Bank have the resources necessary to intensify their support; the IDB is waiting for the United States to move forward with a scheduled replenishment of its basic capital that would allow for a doubling of its disbursements. This increased lending should be conditioned on debtor governments' adherence to economic reform programs.

Fourth, debt reduction agreements must be negotiated between individual debtor countries and their commercial bank creditors. The smallest and weakest debtors require outright relief from much of their obligations. For Latin America's larger countries -- Brazil, Mexico, Argentina, Venezuela, Chile, and Colombia -- smaller reductions are required. Each country faces a different set of problems, and will require different arrangements to deal with their debt burdens. But some measure of debt reduction is essential in each case. Again, such reductions should be conditioned on adequate programs of economic reform.

Fifth, the United States and other industrial countries should actively encourage commercial banks to reach debt reduction agreements with Latin American countries. Changes should be made in regulatory, accounting, and tax practices that would make debt reduction a more attractive option. The crucial inducement, however, will be protection against further losses. The industrial countries must offer some form of guarantees on the interest or principal that remains after the debt reduction operation. The stronger the guarantees, the greater will be the willingness of commercial banks to reduce their claims.

It is clear that no comprehensive debt reduction scheme is likely to gain support from creditor countries or banks. But the

status quo is intolerable. As long as the debtors' interest payments dwarf new borrowing, Latin American countries will remain stuck on a treadmill of austerity, stagnation, and rising debt. What can and should be set in motion now is a step-by-step, case-by-case approach in which each country works out specific, differentiated, and mutually-agreed debt reduction agreements with its commercial creditors.

The economic crisis in Latin America has stimulated a reappraisal of development policies, a recognition of past mistakes and a commitment to economic realism on the part of the political leadership in the region. The experience of several South American countries that suffered under military dictatorships during the past decade has brought about a new appreciation of democracy. The successful transition of Portugal and Spain into stable democracies with modern market economies offer encouragement and hope to the developing countries of our Hemisphere. These are the examples that are perceived as relevant to Latin America.

With few exceptions, Latin American governments want to find a cooperative solution to the debt crisis. They recognize they have little to gain, and much to lose, from confrontation. Latin America's two newest presidents -- Carlos Salinas de Gotari of Mexico and Carlos Andres Perez of Venezuela -- have made this clear. They have called for a reduction in debt payments to a level that is consistent with the imperative of long-term growth. At the same time, however, they are not calling for debt forgiveness, debtor cartels, or unilateral moratoriums. What they and other Latin American leaders are asking for is a genuine dialogue with creditor countries and banks to work out solutions that are mutually agreeable and beneficial.

The restoration of economic health in the Hemisphere is a challenging task. It is also the opportunity to open a new era in inter-American relations.

TABLE I

LATIN AMERICA AND THE CARIBBEAN ANNUAL INCREASES IN CONSUMER PRICES 1987 - 1988

(IN PERCENTAGES)

	1987	1988
atin America	198.9	472.8
rgentina	174.8	372.0
razil	365.9	816.1
hile	21.5	10.9
olombia	24.0	27.7
exico	159.2	70.5
eru	114.5	1,307.1
enezuela	40.3	31.2

ource: United Nations' Economic Commission for Latin America and the Caribbean

TABLE II

LATIN AMERICA AND THE CARIBBEAN EXTERNAL TRADE - 1988

(IN BILLIONS OF $)

	Exports	Imports	Trade Balance
Total for the Region	102.0	74.2	27.8
Argentina	8.6	5.3	3.3
Brazil	33.5	14.5	19.0
Chile	6.9	4.8	2.1
Colombia	6.0	4.4	1.6
Mexico	21.5	18.5	3.0
Peru	2.7	2.7	0.0
Venezuela	10.2	9.6	.9

Source: United Nations' Economic Commission for Latin America and the Caribbean

TABLE III

LATIN AMERICA AND THE CARIBBEAN NET INFLOWS AND RESOURCE TRANSFERS

(IN BILLIONS OF $)

Year	Net Capital Inflows	Net Interest & Profit Payments	Resource Transfers
1980	29.7	18.1	11.6
1981	37.6	27.2	10.4
1982	20.2	38.8	<18.6>
1983	2.9	34.4	<31.5>
1984	10.3	37.0	<26.7>
1985	2.2	35.0	<32.8>
1986	8.3	31.9	<23.6>
1987	13.9	30.5	<16.6>
1988	4.3	33.2	<28.9>

Source: United Nations' Economic Commission for Latin America and the Caribbean

Senator **Sarbanes**. Thank you very much, Mr. Botero. Mr. Freeman.

STATEMENT OF HARRY L. FREEMAN, EXECUTIVE VICE PRESIDENT, AMERICAN EXPRESS, REPRESENTATIVE, AMERICAN AGENDA, NEW YORK, NY

Mr. **Freeman**. Thank you, Mr. Chairman.

Senator **Sarbanes**. Gentlemen, you are doing a very good job of staying with that clock. We are very impressed. Maybe we will learn a lesson from you here this morning. [Laughter.]

Mr. **Freeman**. Thank you, Mr. Chairman. The report of the American Agenda has already been published. I have incorporated the principles in my statement. The points I am going to make, and all of these points were really discussed, should be attributed to myself and my company rather than the American Agenda report.

Some of what I want to say today follows: 1989 to us must be the year when substantial progress is made; that circumstances on both sides of the creditor/debtor relationships are now the most propitious; and that the debt crisis, in fact, is capable of solution. The United States should seize the moment.

NATIONAL SECURITY

First, some perspective. I want to talk about national security, because I and my colleagues at American Express had the experience of working on the United States-Canada Free Trade Agreement, and when we did that, I went to dozens of editorial boards around the country to speak in favor of the agreement. I would talk trade and the editorial boards would talk national security, and we realized that national security was very much in their minds and in others.

We took a different view recently of the debt problem, and this may sound perhaps somewhat banal, but I think it is important to state it this way. If you look at the geography of the Western Hemisphere, there are a few basic facts of life which makes the U.S. position on this very different. If you look at the globe from the top, between the United States and Russia, as the crow flies, is Canada. I think that was a major element in thinking on both sides of the border on the free trade agreement between the United States and Canada.

On the debt problem, to the south is Mexico. We have the only border between a developing debtor country, and a developed creditor country. The United States and Mexico have the only such border in the world. It is 2,000-plus miles. It is essentially a friendly border; we want to keep it that way. Mexico's got 80 million people, climbing quickly to 100 million by the end of this century. So we have a very different situation.

Central America, of course, south of there, is within intermediate missile range, and so forth, and then on to South America.

The point there is that while Japan's participation is critical, Japan's interest in all of this is much more commercial than the United States' interest. It shares no border at all with a developing country. In fact, it shares no border, except an island border with the Soviet Union.

Continental Europe is somewhat in the same position as Japan, with a different kind of a neighbor to its east. It views the whole situation much more in commercial and occasionally in development terms.

So to the rational American observer, though the Atlantic and Pacific Oceans have shielded us over the many decades, this doesn't work for the LDC debt crisis; it is literally next door. Therefore, the United States must be the leader, because we have the most to lose.

As the New York Times stated on November 29, "In country after country, falling living standards"— referring to Latin America—"are breeding a political decay."

We also see upcoming elections throughout Latin America and the Caribbean. We see the rise of parties who advocate complete forgiveness of the debt, debtors' cartels, and the like. A major threat exists to the democratic and market-oriented governments that now are in the majority in Latin America. And we can't overlook George Marshall's tenet that "real security must rest on economic prosperity."

So the truth is and the bottom line is that the United States has the most at risk in the debt crisis.

We think the time has come for a much more aggressive and comprehensive approach. We think the Baker plan bought time, and provided much progress. We are not among those who condemn it or lament it. I think it was good at the time. It is time to move further on. We believe 1989 is the time. Why? We have a new administration that is reviewing this. We know Treasury is actively working on it. We think that the legislation that you passed in the omnibus trade bill mandating a report later this month is critically important to this process. Most American banks and banks in Europe and Japan now have more reserves against LDC loan losses, so that makes them stronger and gives them much more flexibility.

We have a new Mexican President, who came in with a contested election. We think it is in our interest to work with him positively on this, and this is his top priority in foreign economic relations.

We also have a new President in Venezuela, who is in the same position as the new President in Mexico in making the debt question his primary subject. And we have elections coming throughout the year in Latin America and in the Caribbean with this issue at the forefront. So the issue is here; it's now; it's 1989. We have to do something.

BREAKING THE DEBT CRISIS

The truth is, as long as the debt issue is on the table, we will make very slow progress, if any progress, in the debtor countries, in terms of more rapid economic and social growth. The real goal, from our point of view, is not solving the debt crisis. The real goal is breaking the debt crisis and getting it out of the way—getting it out of the way so we can make real progress in economic and social terms, enlarge those markets. We see, as I put in my testimony, perhaps in strong rhetoric, the debt as a monster at the gate. We have got to get rid of the crisis and the debt monster at the gate to get at what we really want. What we really want is democracies in Latin America. What we really want is growth in economic and social terms. We would like those markets back. That is what we want. The debt thing is right in the middle. We've got to get rid of the crisis, get that thing out of the doorway and get on with the real goal.

As each year goes by, the price tag, in terms of opportunity costs, rises. Jim Robinson, my chairman, offered a plan a year ago, called I2D2. It's gotten a lot of attention, somewhat misunderstood, because we viewed it as essentially a plan, not the be-all or end-all. We are delighted to see it's gotten some attention. We thought the Wall Street Journal article that was written the other day talking about chapter 11, was somewhat similar to what we were talking about, although it required legislation, which is a very, very difficult thing to do and in fact, I think, impossible. We can return to that, if you wish.

We have been criticized. Some people think we are trying to bail out the banks, and allege it would cost U.S. taxpayers something they shouldn't pay, as if the U.S. taxpayers weren't already paying something in terms of lost exports, lost jobs, bad debt deduction, revenue losses of the Treasury, either actual or potential, and immigration pressures.

A word on this shibboleth of "bailing out the banks," which we think is a strawman. The analogy of the FSLIC crisis is quite apt. I think everybody in the industry knew that the thrifts were out of control. The price tag was mounting. I think all of us really put our heads in the sand and hoped the magic fairy would take the problem away. Now we have a price tag of monumental size. The taxpayers indirectly or directly will pay some price of what I call eternal nonvigilance. And incidentally, I think the administration's plan looks, on its face, like a very aggressive and reasonable plan that we commend your early attention to.

So we think the phrase, "don't bail out the banks," won't really get us from here to where we have to go. The core criteria in our point of view, and this would make us different from Mr. Williamson's point of view, is that we really think that we have to have some kind of mechanism, which will bring all of the parties to the table, country by country. The chapter 11 analogy made this same point. We think the menu has to be very, very broad. I think we are moving very rapidly in that direction, but we have to go farther. Our idea, and there may be others, is to have mirror facilities in the Bank and the Fund, as sort of the core entity. But we really don't need a new World Bank or a new IMF or a new entity at all. This doesn't require legislation. We need something that everybody that is a party to the deal has an interest in, and comes in free to negotiate—the banks, our government, the other governments, the other debtors and so forth. We really have to go on and try to have a comprehensive approach, country by country.

So the preconditions from our point of view are a really more aggressive, comprehensive approach. As I said, now is the time. I hope when we look back in future years, February 1989 will be the time when there has been some real action.

In closing, I just want to mention, if it is of interest, Senator Wirth mentioned this, that we just did a debt for nature transaction with the Nature Conservancy in Costa Rica, a very large one, I think, 2 weeks ago. It is our second. We did a similar kind of thing with Rev. Leon Sullivan's operation in Nigeria, and we've got a number of them in the pipeline. We have also been one of the leaders in debt equity swaps as well as maintaining a trading desk in debt. So if you want to get back to that, we will be delighted to try and answer any questions.

Thank you very much.

[Complete statement of Harry L. Freeman follows:]

THE LDC DEBT CRISIS:
THE U.S. NATIONAL INTEREST DEMANDS A SOLUTION

By Harry L. Freeman
Executive Vice President
American Express Company

Before the
Subcommittee on International Finance and Monetary Policy
Committee on Banking, Housing and Urban Affairs
U.S. Senate
Washington, D.C.
February 8, 1989

[illegible] Printed in U.S.A. [illegible]

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to testify on the debt burden of the less developed countries (LDCs) and the challenges posed for the U.S.

The sum of my testimony today is that 1989 must be the year when substantial progress is made in this area; that circumstances on both sides of creditor/debtor relationships are propitious; that, indeed, the debt crisis is capable of solution; and that the United States should seize the moment.

First, some perspective:

An often overlooked United States perspective on debt is a national security one, a perspective colored by geography. The national security element of the debt crisis has dramatically increased just in the past few months.

Examination of the globe from north to south in the Western Hemisphere reminds us of a few very basic facts of life. Look at the geography of the situation:

o The only country between the United States and the USSR, as the crow flies, as do missiles and airplanes, is Canada. It is not a pure trade motive that just brought together two historically unlikely free trade agreement partners, the United States and Canada. We have a 4000+ mile border with Canada, friendly and essentially unguarded.

o To the South the U.S. shares a friendly 2,000+ mile border with Mexico, the longest -- in fact, only -- border in the world between a major developed country and a major developing country. Mexico's population is now around 80 million, and heading to 100 million by 2000. The U.S. population is now 250 million, going to 275 million. Last year's $3 billion Treasury loan to Mexico and the fact that President-elect Bush's first unofficial "official" meeting was with the President-elect of Mexico are signs of the importance of the U.S./Mexico relationship. These were wise and timely moves.

- To the south of both the U.S. and Mexico, but within intermediate missile range, lies Central America, a region with poverty and more instability than stability.
- More remote in miles, but sharing the same time zones and nonstop jet flights, lies South America, an area with heavy debt, slow growth and recurrent political instability.
- In contrast, Japan shares no border at all with a developing country.
- Continental Europe has a different kind of neighbor to the East. Africa lies safely across the Mediterranean and the poorest countries lie mostly south of the Sahara.

To the rational American observer, the Atlantic and Pacific oceans have shielded us from many foreign conflicts and problems for hundreds of years. This protection does not exist in the LDC debt crisis. The problem is literally next door. In a November 29th article, the New York Times warned that "in country after country, falling living standards are breeding a political decay." With upcoming elections, the rise of opposition parties which advocate debt forgiveness, the threat to democratic, market-oriented governments is real.

American rhetoric may often stray from the point, but we don't overlook George Marshall's tenet that "real security must rest on economic prosperity." The truth is that the U.S. has the most at risk in the debt crisis.

It is with those principles and geographic perspectives in mind, that I address the private sector's view of LDC debt, and, in particular, my own company's view, most often expressed by its Chairman, James D. Robinson III. We think the time has come for a more aggressive and comprehensive approach to the LDC debt crisis. We think that the Baker Plan has bought time and provided much progress, but in its present form it lacks the resources to solve the problem in an acceptable time frame. We believe 1989 is the year for the next step.

Why?

First, the new Administration which has undertaken a comprehensive review of the problem. We commend that initiative. We fervently hope that the new Administration will come forward with an imaginative and aggressive plan.

Second, the new Administration must report later this month to this Committee and to the House Banking Committee on its recommendations for solving the LDC debt crisis.

Third, most American banks with significant LDC debt exposure have established substantial reserves against those loans, giving them more flexibility. The same is true in other creditor countries.

Fourth, Mexico has a new President who is committed to major progress on the debt issue. It is in our mutual interest to work with him to that end ... now.

Fifth, Venezuela's new President is in the same position of risk and opportunity as the new Mexican President -- an opportunity which must be realized soon.

Sixth, other elections loom in Latin American and the Caribbean. The outcomes of these elections, which can be influenced by the progress we make on the debt issue, are of keen interest to the U.S. in preserving and encouraging democratic governments.

The time is ripe for the U.S. as the inescapable leader to seize the initiative and solve the problem, working with other countries, other institutions, and all the parties to the crisis.

The truth is that, as long as the debt issue is "on the table," there will be slow, if any, progress in the debtor countries toward more rapid economic and social growth, and the political stability and security that goes with it. The debt monster blocks the gate to progress. We must jointly slay the monster, and clear the way for the more important business of building strong and sustainable economic growth in the debtor countries. As each year goes by, the price tag in terms of opportunity costs gets higher. If we act now, we can prevent LDC debt from becoming another FSLIC.

The shame is that the crisis is in fact solvable. The LDC debt arena is not short of ideas for more aggressive and comprehensive solutions to the LDC debt problem. It is short of the political concurrence and will among the industrial

countries to take the indicated steps. Japan can play a large role. European countries must also play a large role. But the U.S. is the biggest economy involved, as well as the largest lender to LDCs. It must change its direction soon and develop, with both debtors and creditors, a solution. The creditor countries must manage the problem; if not, the problem will manage them.

The key to a solution is establishing the conditions for strong and sustainable growth in the debtor countries. For things to get better, there must be both policy reforms by the LDCs and financial relief for them -- new lending, debt and debt service reduction, or both. That financial relief must be sufficient to reduce substantially the current net transfer of resources from the LDCs to the industrial countries, which is now running at $25 billion to $30 billion a year from just the seventeen most heavily indebted LDCs. However, banks are not willing to lend more. They also are unlikely, if not unable, to provide sufficient debt relief on their own. The incentives for policy reform by the LDCs are decreasing as a result. So, someone or something needs to intervene to bridge the gap. And that must be the industrial countries, working through the multilateral institutions.

To this end, my Chairman, Jim Robinson, developed one specific solution, which he offered almost a year ago. The proposal, which we called the Institute of International Debt and Development, or I_2D_2 for short, was meant to show that a detailed solution could be developed. Some have embraced it;

others have found it too complex. Still others say it is not politically realistic.

Some have criticized this and other proposals as "bailing out the banks" -- an allegation that it would cost U.S. taxpayers something they shouldn't pay, as if the U.S. taxpayers weren't already paying something for the continuing crisis through lost exports and lost jobs, immigration pressures, potentially large bank bad debt tax deductions on loan losses, and the actual and potential costs of preserving a sound banking system.

A word on this shibboleth of "bailing out the banks" -- it's a straw man. The analogy to the FSLIC crisis is apt. We all knew that the thrifts were out of control, and the price tag was mounting. But we all put our heads in the sand, hoping that somehow the magic fairy would take it away. Now we have a price tag of monumental size, and the taxpayers, directly or indirectly, will pay the price of eternal non-vigilance.

Political sloganeering, such as "don't bail out the banks," won't get us from here to there. The banks have been taking losses, through write-offs and loan swaps or sales at a loss. More of that will come. Certainly, the banks have taken and will take more hits. Certainly, the Treasury through bad debt tax deductions is already paying some of the price. Certainly, through lost exports and lost jobs due to no-growth debtor economies, American manufacturers, farmers, and workers are also paying a price. The taxpayer's interest lies in a solution, not in a mounting bill.

We have always said that our I_2D_2 proposal was a solution, not the solution. Many other mechanisms exist. Existing exit bonds, debt-to-equity swaps, and the like have been helpful and should continue. But those approaches, by themselves, won't get the job done. Instead, a broader variety of debt relief options are needed to meet the needs of different banks and different countries.

The present menu of options should be expanded to provide more opportunities for debt relief and debt reduction, such as: exchanges of old debt for new bonds at a discount, either by the country itself or by an international institution; interest rate reductions for several years with insurance for the reduced interest payments; and debt buybacks.

We do think a core criteria for a successful plan is the linkage between debt relief and reform of many debtor countries economic growth policies. Market-oriented structural reforms adopted by the LDCs in exchange for meaningful financial incentives -- debt relief and/or new credit -- are the best way to establish the conditions for growth. The objective should be to create a reinforcing cycle in which financial relief provides incentives for sticking to needed economic reforms, and those reforms provide the climate and credibility for new investment, both of foreign capital and of domestic flight capital.

To achieve this linkage, there needs to be some kind of entity or facility endowed by law or agreement with the power to negotiate deals, country-by-country. We think that the most useful and appropriate locus for such a facility is within the World Bank and IMF, most likely two mirror facilities which can operate de facto as one entity.

The mirror facility, initially, if not largely, capitalized by the creditor countries, would have the task of facilitating negotiations between debtor countries and banks to achieve debt relief, establish reform conditions from debtor countries, and monitor progress. Such a facility would have the financial resources to provide guarantees and other incentives that expand the existing menu of financial relief options offered by the Baker plan.

The crux of the matter is that any workable plan must go beyond the scattershot approaches of the present menu. We think that anything short of a coordinated and comprehensive country-by-country approach won't make it. By comprehensive, we mean some facility or forum where the creditor banks and governments, and the debtor countries can agree to a procedure to achieve both debt reduction and economic reform. By comprehensive, we mean linking debt reduction to market-oriented policies and trade liberalization. By comprehensive, we mean that the facility must have teeth, both to bring in the so-called "free riders" among banks and to reinforce LDC commitments to structural reform. While there may be other ways, we think that a combined or mirror Bank-Fund facility is both the glue and the catalyst to such a forum.

Last Friday's Wall Street Journal had an essay suggesting a procedure similar to our bankruptcy law's Chapter 11; we agree

with that kind of thinking. We need a forum with powers to negotiate an all-around approach. We doubt if that can be legislated, but we think the process towards some "authority-by-consent" must begin now.

Since the launch of our own proposal, we have been surprised at how much support from leaders of the world's financial industry exists for publicly supported debt relief. That support continues to grow.

Let me mention one example of many: the American Agenda report of President Ford and President Carter. Mr. Robinson was one of sixteen leading policy advisors that Presidents Ford and Carter drew on for advice, including two former Secretaries of State, the present National Security Advisor, the designated Under Secretary of State, and the present U.S. Trade Representative. In their report, to President Bush, the two former Presidents cited third world debt as one of the six key issues requiring immediate decisions and actions. Any solution, they said, should be based on the following principles:

- It should lead to a reduction of the net outflow of capital from Third World countries. ...
- Cost and benefits must be shared among debtor nations, banks, and industrial countries....
- Case-by-case arrangements should be tailored to the circumstances of particular debtor nations.
- The U.S. should support active roles for the World Bank, IMF, and regional development banks.

- Any new financial instruments created in exchange for debt should be liquid and negotiable.
- Debtor countries should be encouraged, by incentives and penalties, to undertake growth and efficiency-oriented reforms. At the same time debt relief and new loans should be used to encourage Third World countries to protect and not destroy their rain forests and other environmental resources.
- Distinctions should be made between the poorest nations, advanced nations with inadequate domestic policies, and advanced countries with currently sound fiscal policies.

We also note the changing positions of governments in favor of a more comprehensive solution. We suspect a majority of the G-7 countries favor such a solution. We prefer that our own government -- the U.S.-- should join the majority rather than lose a leadership role in a situation where it has the most to gain and lose.

Are we faced with an impasse? I believe not.

The national security concern, most recently prompted by the Mexican election and stance, provides the new Administration with not only the reason to change but a whole new rationale and constituency for change. President Salinas has shifted the LDC debt equation in the most powerful way possible. He is firmly committed to the market-oriented reforms that offer Mexico the best opportunity for future growth and prosperity.

Similarly, President Perez of Venezuela has committed his country to critical economic reforms that will put the Venezuelan economy on a more diversified and sounder footing for future growth. But both new Presidents are calling for relief of their countries' present debt service burdens and reversals of present outflows of financial resources if Mexico and Venezuela are to have the resources for investment and development. It is vital that the U.S. and other industrial countries respond positively and constructively.

As the developments in Mexico, Venezuela, and elsewhere in Latin America make clear, the LDC debt crisis is much more than a banking issue. It's a broad negative on the world economy. For the U.S., its national security element has increased dramatically.

The crisis can be cured. New and more comprehensive measures are needed to reverse the outflow of capital from the LDCs and revive economic growth, as members of this Committee have long argued and as the new Administration recognizes.

The preconditions are in place for a new LDC debt strategy. Many banks are ready and able to accept some form of debt relief or debt reduction, if it is negotiated, conditioned, and not imposed. Many debtor countries have made progress toward market-oriented economies and are prepared to adopt a variety of policy changes. Some industrial countries -- Japan, for instance -- are proposing new approaches. The key country is the U.S. I hope ... and believe ... the Administration will work with the Congress and this Committee to exercise U.S. leadership on this issue.

Senator **Sarbanes**. Well, thank you very much, Mr. Freeman. This has been a very helpful panel.

The trade bill which the Congress passed, of course, included a title in it that requires the Treasury to study the feasibility and the advisibility of an international debt management authority. And that report is due on February 23. That title also required the U.S. Executive Director at the IMF to request the management of the IMF to review the debt burden of the developing countries, with particular attention to alternatives for dealing with the debt problem, including new lending instruments, rescheduling, refinancing of existing debt, securitization and debt conversion techniques, discounted debt repurchases and the international debt management authority, which I mentioned before. The same thing was required of the Executive Director of the International Bank for Reconstruction and Development, the World Bank.

Those two are to be done within a year after the enactment of the act. So there was a concerted effort to get a process going. I think, to pick up on Mr. Freeman now that 1989 may be the year to come to grips with this issue.

I am drawn to some sort of international debt management authority or some approach along that line by the perception that it offers an opportunity to draw in the country's running large current accounts surpluses to assume significant responsibilities for world economic growth, in particular, Japan, but not only Japan. And to do it on an international basis and not on a bilateral basis. My perception is that Japan is doing some of this now, but it is doing it bilaterally, and to that extent, it is structuring it in a way that, as you look down the road, may compound the difficulties with the expansion of world trade, because it will be done in this bilateral arrangement which they are creating rather than expanding it in an international arrangement.

I would like to get your perceptions on this issue of whether, in fact, this Third World debt crisis may not offer an opportunity for reordering the assumption of responsibilities internationally for economic growth and how we can reorder it in a way that it is done on a multilateral or international basis. I would be happy to hear from anyone who wants to address that. Mr. Freeman.

INTERNATIONAL RESPONSIBILITIES FOR ECONOMIC GROWTH

Mr. **Freeman**. If I could take a minute. I gave a talk on this point during inaugural week to the Michigan Republican delegation, after having been introduced as the loyal opposition; my talk was called "The Glass is Half Full."

If you look at where we are and the major events before us—and I will bring this in the debt context in a few seconds—first, we have the GATT round going, which we think is going very well. Having been at the Montreal midterm, which fell apart over agriculture. But after having talked with the principals in the last week or two here and in Brussels, it is looking good, and we are optimistic that we are going to have a broad GATT and strong GATT, and so forth, by the end of 1990.

Second, we expect that the Japanese market will continue to open, although we have to keep pushing.

Third, the Common Market 1992 exercise, which is of critical importance to American companies and their employees and communities, we think will end up, given the new set of commissioners that entered office in the last few weeks, as a major positive for the American economic interests.

If we play that right, we can have major growth, and so forth, around the world. And then you get around to the Latin American countries, and you realize, as I said earlier, that the debt monster at the gate bars progress there.

Therefore, in the context of building the strong GATT, having open access to the Common Market, increasing access to Japan and the others of East Asia, and even the possibility of over time developing a market in Eastern Europe and the Soviet Union, it is the debt crisis that bars the development of a better world economic order for greater prosperity for all of us. It bars that door.

I mean, the old common phrase of the rising tide lifts all ships. We are the biggest ship, and we are likely to be the biggest ship. There is a series of articles in the Wall Street Journal on this that is fascinating. So it is in our national economic interest, which to me is economic as well as national security, to push for a strong GATT, open Common Market, United States-Canada push. We have that. That, I think, will be terrific for Canada and very good for us. A little better for Canada, but very good for us. All of these things, but we've got to slay the debt monster. Break it away and get through to allow those markets and those economies and the social and economic progress to be made. Otherwise, the half empty scenario is very bad for us and even worse for the poor countries.

Senator **Sarbanes**. Mr. Wagner.

Mr. **Wagner**. Our impression, Mr. Chairman, is that the Japanese would be quite interested in participating with additional funds in some sort of program that would address the LDC debt problem, but our impression also is that they will not participate unless the U.S. Government participates. They are looking for a lead from the U.S. Government, and they will join such a program. We believe that other governments would also be prepared to join. We don't think that it is very practical to set up an entirely new agency to operate such a fund. We believe it could be operated through the World Bank or through the IMF, one or the other, depending on the role that this fund was to play. But we think there is money that will come out, but it needs leadership from the U.S. Government.

Senator **Sarbanes**. Do you think it is reasonable to set up the fund, if you do it that way, without altering voting privileges on the theory that this contribution is in part to help rectify the burden-sharing gap which currently exists? The United States spends close to 7 percent of GNP on defense; Japan spends 1 percent. We help to provide a security umbrella. That is constantly pointed to, and we are always trying to remedy it by moving Japan down a military path. That has lots of problems with it in Japan and elsewhere in the Pacific. It may really represent a major mistake in historical terms to move in that direction, but it is very clear that one place where Japan could make a major contribution to help close that burden-sharing gap is in the economic arena, and it seems to me the clearest opportunity on the agenda is in this Third World debt issue.

Mr. **WAGNER**. Well, I think you are right. Whether you could do it without changing voting rights and such. I don't know. Think of it more in terms of the sort of oil facility that was established when the oil price popped, and the Saudis and others came in with funds that were used to help countries that were suddenly under pressure because of the increasing oil prices. A pattern along that line is what we think could be feasible.

Senator **SARBANES**. Senator Shelby.

Senator **SHELBY**. Thank you, Mr. Chairman.

Do the three of you believe that we need an entity to internationalize this debt? Certainly these countries need debt relief, but our banks cannot shoulder this debt burden completely, at least not immediately. Mr. Freeman.

INTERNATIONALIZE DEBT

Mr. **FREEMAN**. We think that you need some kind of international facility not an agency, to make a big distinction there.

Senator **SHELBY**. Yes. An entity of some kind.

Mr. **FREEMAN**. Yes. But it doesn't necessarily have to be a buyer. What we think is—let's say that the World Bank today established a facility and the IMF established a facility and they were identical, you would have a de facto agency. It doesn't require legislation; it requires the political will by the leading members of the Bank and the Fund. Then you get the banks from here and Europe and Japan and the debtor countries together, agree that they will have a conference and figure out how to resolve this country by country. You can do that. That does not require legislation. In fact, I don't think there is any legislation I can think of, other than what you did in the Omnibus Trade bill, that is really going to be helpful.

Senator **SHELBY**. Maybe we do not need legislation, but we do need a lot of willingness to work with these other industrialized nations that are at risk. The debt issue places the democracies of several South American nations at risk, wouldn't you think?

Mr. **FREEMAN**. Yes, sir. Senator, I think, as you have, we have talked to officials in other governments, and I think if the United States came up with a plan, maybe within the next few weeks, I think most of the other G-7 countries would leap with joy and come on board. That could be wrapped up this spring, no later than the economic summit. I think other governments are very anxious to resolve this, and they are very anxious to resolve this soon, and they are essentially counting on a new administration having a new look at this and seizing the moment. So I think, when I say the time is propitious, it is based not only on what we see here but what we see around the world, Europe and Japan. But you do need, in our view, some kind of facility, authority or something, and we think the Fund and the Bank are the best places to do that.

The problem with the Fund and the Bank is that they are not adventurous. And they are not going to do that without a lot of push from the key member countries, and the key is the No. 1 member country—us. So without our pushing, the Bank and the Fund aren't going to do much.

Senator SHELBY. Do you gentlemen agree with that?

Mr. BOTERO. Senator, I would make the point that more important than the institutional arrangement is the political will. It is useful to keep in mind that there is a time problem here, and events may shorten the time period in which the international financial community——

Senator SHELBY. It is a political and an economic time bomb, isn't it?

Mr. BOTERO. That is right. Now it has been proven in past events that the G-5 or the G-7 can act very rapidly, very informally through the mechanisms that they have already, the Plaza Agreement, the Bank for International Settlements, the Paris Club. So, should the political will be there in this country, and I believe in Europe it already exists, and in Japan, increasingly so, I am convinced that the mechanics will fall into place, either by a facility in one of the Bretton Woods institutions or via some other kind of arrangement that could be structured, as I say, easily. But the fundamental thing is that the political will be there. The moment the governments of the major industrialized countries, but beginning with the U.S. Government, give the instruction to their financial authorities: "Act," the mechanism, I think will become secondary.

Senator SHELBY. Mr. Wagner, do you have any comments?

Mr. WAGNER. I don't think we should set up any sort of new or different entity. If there were added funds available to flow through the World Bank and used on a case-by-case basis, I think that would help the process. It's not going to solve it overnight. This is a slow process. Some countries are going to make good steps forward and others aren't. As Mr. Botero said, it isn't easy to make the adjustments in these countries that have to be made.

Senator SHELBY. Do you believe we have got to link the internal economic reforms in these countries to external relief in order to make those economies work?

Mr. WAGNER. Well, there's a carrot and stick operation here, and it's a delicate operation. In some cases you need the stick and in some cases you need the carrot and you need someone who has the judgment to handle that in such a way that it's most effective. Probably people with the experience of the World Bank and the IMF could best administer something like that.

Senator SHELBY. Thank you. My time has expired.

Senator SARBANES. Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

Let me first thank you gentlemen for coming today and presenting your views and the views contained in the various studies that have been conducted. I'm eager to deal with this problem. My difficulty is that I can't throw out everything that I know about my own real life experience in Texas and the United States to address this issue.

Mr. Botero, I hear you talking about this Third World debt problem, and I'm struck by the fact that I never hear more credit presented as a solution to any other debt problem except that of Third World debt. I never hear it proposed in the real world that I live in, that the way we help a guy who can't pay off his debt is to rush in and lend him a lot more money.

I hear your talk about political will of the debtor, but despite the way we glibly say, of course, we're going to have to have economic reform, I do not see political will from the—you were talking about political will from the creditor nations—I don't see political will from the debtor nations.

Let me just give you some evidence of that. The Wall Street Journal on the 23d of last month had a little table on the market value of Third World debt. They have six Third World debtors on the table, and they have the discount rate on their debt.

Now I don't know a better index. Go out and look in the marketplace to find out what these countries are really doing about reform. I start here with Argentina. In July 1985, their debt was discounted to about 60 percent. It's now down to 18 percent. So if they've been doing any reform under these programs the market has yet to discover it.

In the case of Brazil, they have fallen from 75 to 34 percent, Mexico, from 80 to 38 percent. Peru, which has practically repudiated its debt and miraculously the market has discovered it, the market value of its debt has fallen from 45 to 5 percent, Venezuela, 81 to 37 percent.

The only country where there is obviously any reform going on in the mind of the marketplace is in Chile. The debt was discounted at 65 percent in July 1985. It's discounted at 60 percent today. So obviously by market tests, they're doing something.

The more I listen to all these schemes about dealing with the problem and the more I look at the lack of action by debtor nations, the more I'm convinced that it's going to be very difficult. We talk about political will on the part of the guy that loaned the money but we need to get the people that borrowed the money to exercise political will.

I tried to convert your example about 100 units into something I can understand and it suddenly struck me that about a third of all the units I earn go to my mortgage. If I could just get the company that holds my mortgage to forgive that mortgage, I might be able to send my son to Harvard University. If I could just convince the mortgage company that I can't do what I have to do and pay that mortgage. That seems to be the logic behind much of this debt relief talk.

And let me say, Mr. Wagner—and then I'll stop and ask some questions—if you can get this deal going to unlock capital by tax credits, we've got a lot of capital we would like to unlock in Texas. Many people would like to donate condominiums to the homeless if they could only get a tax credit from the Federal Government to do it.

The problem is, where does the Federal Government get this money?

So let me begin with a question and just run it beginning with you, Mr. Wagner. If we could come up with some way of restructuring debt or expanding lending, how can we get any kind of realistic guarantee that the nations that are involved are going to institute the only economic reforms that have produced economic growth in the postwar era, and that is allowing market systems to work?

Mr. **Wagner**. There is no guarantee. There's no way you can get any perfect guarantee. We try by trouncing the money we release.

We release it over a period of time. And the difficulty with that is that your money is released in a rather short period of time, let's say 2 years or so. That isn't really a long enough period to ensure that any reforms are implemented in a way that ensures they will be there for an ongoing period.

Your best leverage is their future need for resources. The fact that they have to come back in the future and you have a chance to review, and you have opportunity to judge the performance for the countries. Colombia has performed pretty well. So has Chile. These countries have the chance of getting support and should receive it.

Others, you can't help but be skeptical of an Argentina that's had a poor record on the economic scene. So there isn't any guarantee.

I might just take 1 minute to comment on the secondary market for LDC debt. It's a very thin market. There aren't many buyers out there. What has happened is that there are a large number of small transactions on the market to be sold and you find that a good bit of this market is not a cash market. A lot of it is a swap market where people are swapping one country against another.

So it's a market, but it isn't a very good indication of what the holders of the debt judge is the true value of it.

Senator **Gramm**. Well, let me just inject, if that were right and the debt is undervalued, why is your bank not buying it up?

Mr. **Wagner**. Well, we've got enough as it is. But somewhere along here it's going to become attractive. There are going to be some punters who are going to be in there taking a shot at some of this debt.

Senator **Gramm**. Well, I'm out of time, but if you see them, you tell them we're on the lookout.

Mr. **Wagner**. We'll send them down to Texas for you, Senator.

Senator **Sarbanes**. Actually, the fact of the matter is now is that in that secondary market the lean creditor takes a hit when they dispose of it at a discount. Isn't that correct? But the debtor country gets no benefit from the fact that their creditor has recognized the loss. They are still held to the full value of the debt on the part of the acquiring party. Isn't that correct?

Mr. **Wagner**. That's correct.

Senator **Sarbanes**. Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman.

As I was listening to my Germanic cousin, Senator Gramm from Texas, I was struck with the similarities of this issue and the savings and loan crisis that is dominating the headlines today.

It seems to me that there are so many analogies, including the fact that, yes, we did try to solve the S&L crisis by giving more credit to institutions and so a Vernon Savings which started out as a minuscule problem now has threatened to take down the entire industry. We have attempted to meet the requirements of paying interest to old depositors by borrowing new money. We have attempted to assume that the marketplace alone is the means of solving this problem, rather than recognizing that there is a duality of marketplace and appropriate role for effective government regulation.

I think all those and other similarities between the S&L crisis and this current situation should make us a little less arrogant as we suggest that we know precisely and have some divine inspiration and holy grail as to how to deal with this problem.

One of the issues that's concerned me is that we don't have a very clear report card as to how we're going to judge our progress. We are debating whether the Baker plan worked or didn't work without having some standards by which to attempt to quantify that. It appears as if we may be launching off on some new solutions, again without a clear understanding of how we will evaluate in 1991 or 1992 whether these solutions are working.

So let me ask this question. If you had to look at half a dozen quantifiable economic indicators of past success and of future success in our efforts as a nation and as a world to deal with the Third World debt problem, what would you punch up on your computer on a monthly or quarterly basis?

ECONOMIC INDICATORS FOR SUCCESS

Mr. Botero. That's a rather difficult question, Senator, but I will mention two or three.

You can quantify net inflows of capital and in fact at the time of the Baker initiative that was an indicator. It was a loose target because obviously there were many actors involved, but as I recall the figure was something of the order of $20 billion per annum. And to give you an idea, in 1988, that inflow was $4.3 billion. So that can be a target of what is required.

You can also hold a target on the part of what the country should be doing on their investment and their savings rate. You can target very clearly the size of the public sector deficit as a percentage of GNP. The indicators of domestic effort are well developed and the advantage of having the IMF and the World Bank aboard on an exercise of this nature is that there's a long tradition of accepting those criteria, monitoring them, and complying and in fact conditioning disbursements to those green lights. So you could very well design four to five indicators on your measuring internal effort and measuring your fiscal effort, seeing what is being done in the field of privatization, seeing what is being done on your exchange rate, if you're keeping it in line, what is being done to stimulate domestic activity.

If I may take half a minute, I really would not like to leave unchallenged Senator Gramm's statement that there has been no effort on the part of the Latin American governments. Senator, I cannot go into it right now because we don't have the time, but the World Bank will provide you a country-by-country list of what is being done in Latin America to slash budgets, to raise taxes, to cut government spending.

There are countries where incomes have been reduced by 40 percent. There are countries that have slashed—in the case of Bolivia—and Jeffrey Sachs will tell you in detail—that have sacked tens of thousands of workers from the national tin mines. You can go across the line. Mexico has allowed one of its national airlines to go broke. And so on and so forth.

There's no question today that governments of Latin America in these 7 years now of the debt crisis are acting in a very realistic way and in no way are expecting the world to owe them a living.

The problem with your mortgage example is that if your mortgage were at 1 year maturities, you would quickly find that you couldn't pay it. What you would have to settle with your bank is that that mortgage be restructured in a reasonable period of time.

Part of the debt crisis is so much of the debt toward the final years of the debt crisis was contracted at 1, 2, 3 years, maturities, and some of it at 6 months. And you cannot finance development in those periods of time.

So it's not a question of just piling more debt on top of existing debt, but putting it on reasonable terms.

Thank you, Senator. I apologize for taking part of the time for your questions, but I really thought that I should leave on the record an answer to Senator Gramm.

Senator **Sarbanes**. Mr. Freeman, did you want to reply to Senator Graham's question?

Mr. **Freeman**. Senator Graham, let me try to answer your point this way. Perhaps the question is, how do you know if you've won or how would you define winning?

I think in this case it's hard to achieve but it's simple to see it. Winning country-by-country is when normal economically based commercial lending goes on. So in the case of Mexico, in which it is not happening but I think Mexico is the first country we should work with, the goal is to get Mexico and the banks of the world—whether American, Japanese, European, Canadian—to make truly voluntary loans on a commercial basis to Mexico and to the other countries, and when we have achieved that, that's when we have won.

When we talk about resolving the debt crisis, we're not talking about repaying the debts. We're talking about a reduction in the debt or reductions in the interest rate to the level where you can resume the normal commercial life of that country, lending, export financing, and all of the other real market indicators that come into play. That's winning.

Senator **Graham**. I wonder if Mr. Wagner had any comments on what he thinks should be on the report card?

Senator **Sarbanes**. Mr. Wagner.

Mr. **Wagner**. Well, we run tables constantly on all these countries. I've got some right here. And they show all kinds of performance data going back 5 or 6 years. We look most closely at certain ratios. Among those are the total debt to exports, the reserves to imports, interest coverage, these sorts of things. But then we take into account the overall progress on trade balance, current account, all that sort of thing. But those three ratios we watch closely as a sort of leading indicator of when a country is headed toward trouble. They cross certain ratios and the yellow caution lights go on. We run these for countries all around the world. The performance ratio pattern has held up pretty well.

But as Mr. Botero said, really, the IMF is excellent at coming up with report cards. I'm sure that it would be quite interesting for you to ask them to give you a few examples of their report cards, not ask them to give you their big thick reports but boil one down to one page, and performance, or lack of it, shows up quite quickly. You can see where they're getting into trouble and where the problems are.

Senator SARBANES. Senator Wirth.

Senator WIRTH. Thank you, Mr. Chairman.

Let me if I might return to the question that I alluded to in my opening statement related to debt and the environment and use as a specific example what is going on in the Amazon.

To set the scene just very briefly, Mr. Chairman, the rain forest in the Amazon is an enormously important worldwide resource for ecological reasons and others. It's responsible for 20 percent of the water in the world. The hydrologic patterns there have everything to do with the climate in South America, and there is increasing understanding of the impacts the Amazon has on the climate of North America and other areas around the globe. We don't really know everything that's there, but probably 50 percent of the world's species exist in the Amazon. This is an extraordinarily rich genetic pool. And as the Brazilians call it, these forests are the lungs of the world, responsible for the development of a lot of the oxygen that all of us breathe. So the Amazon is extraordinarily valuable.

The Amazon is being torn down, as you know, Mr. Botero, at the rate of a football field a second. It's as if there were a large monster coming along the landscape just chewing it up.

Now there is a growing awareness within Brazil that the development policies they have been pursuing have to be changed, that those practices Senator Heinz was referring to earlier were a disaster. The Brazilians are removing the incentives for ripping down the rain forest, but they don't have any funds to take care of it.

Brazilians are realizing that it is in their interest to manage and take care of the rain forest. We and other countries around the world are realizing that it is in our interests too, for the purpose of the sheer survival of the globe, to take care of the rain forest.

So there's no debate that there is a confluence of interest. The question becomes how to do it?

During our trip to South America we were posing and slowly building on the notion of setting up some kind of a foundation in Brazil using discounted debt—and I want to talk about the mechanism. There's a lot of discounted debt in the United States and elsewhere, and many European countries are interested in this as well. In some fashion the debt would be used to set up a foundation in Brazil. Foundation funds in turn would be invested and managed. Income from those investments would pay for the management of the forest and the forest rangers, and for the research, the training, the experiments on extractive reserves and commercialization and so on—all of the things that everybody agrees has to be done.

The Brazilian Government has been resistant to this. But as you have seen they have slowly but surely come around and say let's start talking about this. Thus the concept has gained a great deal of momentum, pushed in particular by the foreign ministry and the finance ministry of Brazil. The willingness to consider the idea is an enormous breakthrough given the very justifiable concerns of nationalism and a lot of historic xenophobia.

Having laid the concept out, it is in everyone's interest to figure out how to do this. The question then becomes: What are the various alternative mechanisms for getting debt into such a foundation? You mentioned earlier, Mr. Wagner, the possibility of a tax writeoff. Second, there are possibilities of involving people who want to do business down there; one of the costs of doing business could be a contribution of a certain amount to this kind of a foundation.

A third possibility are the writeoffs, Harry, that I think you were suggesting in your comments. A lot of debt is written down anyway, so you have the possibility of contributions of the written down debt.

The fourth possibility involves outside individuals—and we're not talking about vast amounts of money here—people just buy discounted debt and make the contribution to the foundation.

I spent time defining some possibilities because it is of such extraordinary importance to everyone that we figure out how to do this and to do it rapidly.

Mr. WAGNER. Well, if I can comment on that, Mr. Chairman, we have spent some time thinking about this over the last 3 years and worked with Tom Lovejoy.

Senator WIRTH. Tom was with us on the trip and helped to put it together.

BRAZIL

Mr. WAGNER. He's familiar with a lot of what we've talked about as is Bill Rieley. We have spent quite a bit of time on this. The problem it comes down to, if we take Brazil, for example, is to get money there to start working and doing something.

The fact is that very little of the Brazilian debt has been written off. Brazil, all of us look upon it, potentially has many resources and the ability to recover, so we don't see that it justifies writing it off. So it's not a country where you—it's not a Sudan where you can have people give you the debt because they've written it off—or a Nicaragua or a Poland or something of that sort.

If you tie it to a certain amount of funds being made available from those who are investing there, I'm afraid it's going to be a slow process of building it up.

What we have in mind is right now what do people do with their Brazilian debt? Well, they sell it. And if you sell it, you're selling 40 cents on the dollar, you get a 60 cents loss which you take and then you get 40 cents in cash. If you donate it, you get a deduction against your taxes, which is worth about 16 cents or something like that.

Senator WIRTH. Is that deduction against the 40 cent value or against the full value of the dollar?

Mr. WAGNER. It's against the 40 cent value. What we're saying is we're not saying you give an open ended tax credit on all this business. You put some limit on the amount that's allowed. But what you need in Brazil is probably something like $100 million or so to have some effect.

Senator WIRTH. As a start.

Mr. **Wagner**. Yes. But you could say each year in Brazil we will allow $40 billion of tax credits for donations made for this foundation.

Senator **Wirth**. By saying "we" you mean the Treasury, the IRS?

Mr. **Wagner**. Yes, the IRS has to do it. Now we have not gone and looked at what has to be done to encourage donations from Germany or Canada or Japan. We have looked at our own situation.

If that happened, then we think it pretty much balances up as to whether you make a donation or you sell it. So the choice becomes one that's almost equal for a bank that wants to get out of Brazil. I think that will unlock the flow of money into these foundations, but it will take something like that to get the kind of funds you need. Otherwise, you can go and say, sure, let's get donations from people who are interested in this problem to go buy the debt, but you're going to get $3 million, $4 million, $5 million to do it. It's going to be a very, very slow process and it's a matter of priorities. How important is Brazil and this issue? And is the U.S. Government prepared to make some sort of tax concession on this and you can limit it, put a limit on how much it is. It doesn't have to be an open ended provision. That's what we're thinking.

Senator **Wirth**. Mr. Freeman.

Mr. **Freeman**. I think, as I said earlier, Senator Wirth, we have done a couple of these and we've got a number in process. There is a point perhaps that hasn't been mentioned and that is that there is a certain visibility, or if you will, public relations value in this.

We did this transaction in Costa Rica where we had written off the debt. I wouldn't suggest that had anything to do with the creditworthiness of Costa Rica, because we have been following an extremely conservative accounting practice. However, I think somebody told me the other day that the American supporters of the Nature Conservancy and our American Express Cardmember base have great overlap. So we did a deal. We get a deduction for the fair market value of the debt at the time since we had written it off and were selling it. We sold it for something like $1 million, but they have $3 million of income that's converted to local currency and spent to buy land that the Conservancy wants to buy.

But I would not minimize the commercial visibility and, if you will, marketing or public relations aspect to this. If you have a company such as mine and others that are involved in this problem, both in the United States and in Brazil or other places, you do have a stake in that market. You want to be doing something that's consistent with your business and enhancing this kind of thing is consistent with a lot of businesses.

Senator **Wirth**. Thank you all very much.

Senator **Sarbanes**. Thank you. I'd say to the members of the subcommittee, it's my intention now to go on to the next panel unless any member has a particularly burning question they would like to put to this panel and to hold them here.

Well, gentlemen, you've been most helpful and we appreciate it. We appreciate the care that went into the prepared statements that were submitted which will be included in full in the record and your responses during the course of the subcommittee hearing. Thank you very much.

Senator **Sarbanes**. If the next panel would come forward, Mr. Schulmann, the managing director of the Institute of International Finance; Professor Sachs from Harvard; and Professor Hanke from Johns Hopkins.

Mr. Schulmann, we will lead off with you. The Institute of International Finance, whose members are primarily international commercial banks—actually, you might take a moment just at the outset to profile the Institute for the purposes of the record—but has issued just last month a report entitled, "The Way Forward for Middle Income Countries" discussing this debt question and you are the managing director of the Institute and I think have since its conception, if I'm not mistaken, and we would be pleased to hear from you.

STATEMENT OF HORST SCHULMANN, MANAGING DIRECTOR, INSTITUTE OF INTERNATIONAL FINANCE, WASHINGTON, DC

Mr. Schulmann. Thank you very much, Mr. Chairman.

My name is Horst Schulmann. I am the managing director of the Institute of International Finance and I have been in that office since 1987. The Institute has 185 member institutions in 40 countries of the world; one-hundred and sixty of these institutions are commercial banks, among them 33 banks from the United States.

We are engaged both in tracking economic and financial developments in some 50 middle-income countries as well as serving as a forum and catalyst for our membership on banking issues regarding the 15 heavily indebted Baker plan countries.

As you pointed out, Mr. Chairman, last month the Institute issued a report which is a consensus document on ways to move forward in resolving the problems of these middle-income countries. I believe that copies of this report have been made available to all members of the subcommittee and I request your permission, Mr. Chairman, to put the text of the report in the official record.

In my brief remarks this morning I would like to elaborate on three or four key messages in the report.

FORCED FORGIVENESS OF DEBT BY LAW

Let me start by saying that, first of all, the call from many sides for governments to force commercial banks by law to forgive debt is seriously misplaced. Mandated forgiveness would certainly be contested in the courts and in the interim—that is, until such time that final judgment was rendered—banks would wind down voluntary trade and interbank financing and would no longer be prepared to lend new money under the concerted lending process established in 1982.

Both here and abroad, it would also be viewed as grossly unfair and politically untenable to forgive the debts of these middle-income countries without granting similar relief to private debtors in the industrial countries which have experienced hardship.

Forgiveness, finally, would also do nothing to get at the key requirement to modernize the economies of the middle-income countries through structural reform.

In contrast, however, Mr. Chairman, many banks are prepared to engage in voluntary debt reduction transactions, such as debt-for-equity swaps, for example. Some $25 billion in debt reduction has been achieved in the last 2 years alone. That's the equivalent of almost 10 percent of the commercial bank debt of the Baker 15 and Chile has already reduced its bank debt by more than one-third.

We believe that significant debt or debt service reduction can continue. Existing bank claims will be traded or sold for equity or alternative debt claims if the new asset is perceived to be of better quality. The debtor country, of course, can improve matters by opening its economy to greater private sector initiatives, by privatizing sections of its economy, and by encouraging foreign investment through so-called debt-for-equity swaps.

Where this occurs, residents of the country and foreign investors will take advantage of the secondary market to acquire debt for conversion into equity. This is clearly the best way to handle the severe decline in capital investment which—if not reversed—will put these countries at a competitive disadvantage on world markets for years to come—and better investment opportunities, Mr. Chairman, are also the best way to attack the capital flight problem.

The international financial institutions can also assist those countries taking the right steps by providing selective credit enhancement on the new claims received in exchange for present bank claims.

For instance, the World Bank could guarantee interest on new debt claims for the first few years and renew the guarantee if the country continues to meet performance objectives. The appropriate mix between voluntary debt reduction and new loans must be decided on a country-by-country basis. It is abundantly clear, however, that the longer term objectives of the major middle-income countries cannot be met without access to the global capital market and that means they must return to creditworthiness or else become dependent on inadequate levels of official grants and loans from the industrial countries.

In the interim, until they regain market access, new money requests and voluntary debt reduction programs must be closely coordinated and carefully managed so that banks have incentives both to lend new money and agree to exchange old debt.

As we've seen in the Brazilian financing in 1988, new money and voluntary debt reduction can go hand in hand.

OVERALL ECONOMIC GROWTH IS INADEQUATE

Another key message of our report is that although substantial progress has been achieved by some of the middle-income countries, overall the pace of economic growth is inadequate. Many of these countries now recognize the crucial role of the private sector and the need for greater outward orientation of business and they need to persevere in their efforts.

Stronger actions, however, are also required by creditor governments to accelerate the growth potential in the debtor countries. In addition to providing a stable general environment through appropriate fiscal and monetary policies, the creditor countries must be more forthcoming in resuscitating the process of concerted official and commercial bank interaction which characterized debt management strategy a few years back.

The banks joined with official lenders at the inception of the debt rescheduling exercises in order to keep the financial system together, but today as the threat to the system had dissipated, a new rationale is needed. Banks are in a much stronger position in regard to capital growth and sizable loan loss provisioning to scrutinize and accept or reject each new loan request and voluntary debt reduction proposal.

For this reason, we believe better cofinancing opportunities with the World Bank and selective credit enhancement from the official side both on new loans and voluntary debt reduction transactions are needed to keep banks in the process.

The banks are looking for active cooperation and coordination with the official sector so that the leverage each side can exert both in raising new loans and expanding the volume of voluntary debt reduction will benefit the concerted strategy.

The last message from the report which I want to underscore this morning is that banks are prepared to consider multiyear financing commitments if similar commitments are offered by official lenders. Banks understand that governments in the middle-income countries need assurances of medium term financing support if they are to introduce and carry through politically sensitive but necessary adjustment programs. We must be prepared to help those countries which exhibit a sustained seriousness of purpose in reforming their economies.

Thank you, Mr. Chairman.

[Complete prepared statement of Horst Schulmann follows:]

Statement of
Horst Schulmann
Managing Director
Institute of International Finance
before the
Senate Subcommittee on International Finance and
Monetary Policy
Washington, D.C.
February 8, 1989

My name is Horst Schulmann. I am Managing Director of the Institute of International Finance. The Institute has 185 members, primarily commercial banks, in 40 countries. We are engaged both in tracking economic and financial developments in some 50 middle-income countries as well as serving as a forum and catalyst for our membership on banking issues regarding the 15 heavily indebted Baker Plan countries. The Institute does not generally engage in attempts to influence U.S. governmental policies or public opinion for a specific economic purpose.

Last month the Institute issued a report which is a consensus document on ways to move forward in resolving the problems these countries face. I believe that copies of this report have been made available to all members of this subcommittee and I request your permission, Mr. Chairman, to put the text of the report in the official record.

In my brief remarks this morning I would like to elaborate on several key messages in the report.

First, the call from many sides for governments to force banks to forgive debt is seriously misplaced. In the United States, outright mandatory debt cancellation would be an unconstitutional taking of property unless prompt, adequate and effective consideration were afforded. Mandated forgiveness would certainly be contested in the courts. During the interim, before final judgment was rendered, banks would wind down voluntary trade and interbank financing and no longer be prepared to lend new money under the concerted process established in 1982. Both here and abroad it would be viewed as grossly unfair and politically untenable to forgive the debts of these middle-income countries without granting similar relief to private debtors in the industrial countries which have experienced hardship. Forgiveness would also do nothing to get at the key requirement to modernize the economies of the middle-income countries through structural reform.

In contrast, many banks are prepared to engage in voluntary debt reduction transactions. Some $25 billion in debt reduction has been achieved in the last two years alone. Chile has already reduced its bank debt by more than one third. Significant debt or debt service reduction can continue. Existing bank claims will be traded or sold for equity or alternative debt claims if the new asset is perceived to be of a better quality. The debtor country itself can improve matters by opening its economy to greater private sector initiatives by privatizing sections of its economy and encouraging foreign investment through so-called debt-for-equity swaps. Where this occurs, residents of the country and foreign investors will take advantage of the secondary market to acquire debt for conversion into equity. This is clearly the best way to handle the severe decline in capital investment which, if not reversed, will put these countries at a competitive disadvantage on world markets for years to come. Better investment opportunities are also the best way to attack the capital flight problem.

The international financial institutions can also assist those countries taking the right steps by providing selective credit enhancement on the new claims. For instance, the World Bank could guarantee interest on new debt claims for the first years, and renew the guarantee if the country continues to meet performance objectives.

The appropriate mix between voluntary debt reduction and new loans must be decided on a country-by-country basis. It is abundantly clear, however, that the longer-run objectives of the major middle-income countries cannot be met without access to the global capital market. They must return to creditworthiness or become dependent on inadequate levels of official grants and loans from industrial countries. During the workout period, until they regain market access, new money requests and voluntary debt reduction programs must be closely coordinated

and carefully managed so that banks have incentives both to lend new money and agree to exchange old debt. As was seen in the Brazilian financing in 1988 new money and voluntary debt reduction can go hand in hand.

Another key message of our report is that although substantial progress has been achieved by some of the middle-income countries, overall the pace of economic growth is inadequate. Many of these countries now recognize the crucial role of the private sector and the need for a greater outward orientation of business. They need to persevere in their efforts.

Stronger actions are also required by creditor governments to accelerate growth potential in the debtor countries. In addition to providing a stable general environment through appropriate fiscal and monetary policies, the creditor countries must be more forthcoming in resuscitating the process of concerted official and commercial bank interaction which characterized debt management strategy a few years back. The banks joined with official landers at the inception of the debt rescheduling exercises in order to keep the financial system together, but today as the threat to the system has dissipated, a new rationale is needed. Banks are in a much stronger position as a result of capital growth and sizable loan loss provisioning to scrutinize and accept or reject each new loan request and voluntary debt reduction proposal.

For this reason, we believe better cofinancing opportunities with the World Bank and selective credit enhancement from the official side, both on new loans and voluntary debt reduction transactions, are needed to keep banks in the process.

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The last message from the report which I want to underscore this morning is that banks are prepared to consider multi-year financing commitments if similar commitments are offered by official lenders. Banks understand that governments in the middle-income countries need assurances of medium-term financing support if they are to introduce and carry through politically sensitive, and necessary, adjustment programs. We must be prepared to help those countries which exhibit a sustained seriousness of purpose in reforming their economies.

Senator SARBANES. Thank you very much.

Professor Sachs.

STATEMENT OF JEFFREY SACHS, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, BOSTON, MA

Mr. SACHS. Thank you very much for the opportunity to be here this morning.

I am very gratified with what I've heard from most of the speakers. It has been painfully clear in my view since at least late 1985 that this process was taking us into the rocks and that Latin America was going to fall into economic and political disarray if we continued with the strategy that our Government has been embarked upon since 1982 and the rhetoric, fortunately, is now changing in terms of what we ought to do.

The reality is, we are on the rocks. This process has broken down completely. Even the structure of the so-called Baker plan is nowhere to be found. There were only four attempts at new money packages in 1987 and 1988 in the whole world. That's with 42 countries that are in the process of commercial bank debt restructuring. And of those four cases—that's Argentina, Brazil, Ecuador, and Ivory Coast—Ecuador and Ivory Coast never got a penny because the packages didn't get off the ground. Argentina collapsed a couple of months after the agreement was signed and is now 9 months in arrears and Brazil, with an agreement signed September 22 of last year in what was hailed by the banks as a great step forward, has basically broken down as well with an announcement a couple weeks ago of some unilateral steps by the Brazilian Government to change the terms of the agreement because the agreement was just untenable.

I would suggest to you that the situation is absolutely urgent. It has been clear to those of us who go regularly to Latin America—and that is on my part every couple of weeks or so—that there is such a perception gap between the realities in Latin America and what people understand here of what's going on that it was obvious as much as 3 years ago that we were just on a course which could not get the Latin American economies back on their feet.

HYPERINFLATION

You now have a hyperinflation in Peru. I point out in my testimony this morning that I worried about that explicitly in testimony to the Senate in early 1986, that we were going to have a collapse, and indeed we do have a monumental social and economic and political collapse in Peru.

You have hyperinflation underway in Brazil. You have an Argentina that can't keep the lights on any more literally. They can't run the refrigerators. They can't keep milk in the houses in Buenos Aires. The infrastructure has collapsed. You have a continent that is in unilateral suspension by and large except for two or three of the largest debtors that we strong arm as much as possible to keep them paid.

So this idea that there actually is a process left right now is, unfortunately, a tremendous distortion of where we stand.

Too much of the time we think about this crisis in terms of two or three countries. That's Brazil, Argentina, and Mexico because they have two-thirds of the United States bank exposure right now. There are 42 countries in the world with 800 million people that are engaged in commercial bank debt restructurings. Nobody even talks about the other 39 or let's say the other 35 or 36 and I can tell you that for at least half the rest of them they're in complete suspension. The idea of new money is impossible. They have lost their trade credits. The political situation is crumbling. We need a systemic approach. We have to get away from this idea that these new money packages and multiyear financings and so forth are going to do the job.

Those are statements that apply to Mexico and Brazil perhaps, although I don't think they apply there either, but no one is even thinking about the bulk of the countries in the world and that's because our banks don't have much exposure there, in terms of the bulk of their own exposure, although the debts are high from the perspective of these countries.

VOLUNTARY DEBT REDUCTION

In my testimony and in some technical papers that I will leave with the committee I try to point out that this idea of voluntary debt reduction is absolutely a nonstarter, to use a famous expression in this game. Voluntary debt reduction is akin to voluntary bankruptcy. We don't have it. We will never have it. It doesn't make sense. You don't have voluntary bankruptcy because each creditor says, "Great, I believe the debt should come down. Let him give the debt reduction." And that's essentially what happens right now. Everybody talks a good game on the voluntary debt reduction, but it's not going to happen because of this fundamental collective action problem.

Moreover, it's not going to happen for any of the 35 or 36 small countries because nobody wants to set precedents and I've seen that with Bolivia where I have been assisting the Government in restructuring the debt. Citicorp has basically said, "We don't want you out of this problem." We had a debt buyback for Bolivia. There were 16 U.S. banks with exposure; 13 got out entirely. Citicorp, Bank of America, and Morgan held onto their debts. We had a commitment by the chairman of the steering committee that there would be a second round which would take Bolivia out of this misery, but when the time came for a second round and there's discussion underway right now, Citicorp says, "No second round. London Inter-Bank Offer Rate [LIBOR] plus two. Those are the terms we're going to give you." This is what voluntary debt reduction is all about.

A few of the big banks can hold up the process and they have all sorts of reasons to hold up the process. They don't want to make precedents. They don't care about the little countries. And also, they have the view of let the other guys get out; we're not going to get out. That's what voluntary debt reduction is really all about.

Furthermore, the big banks are still expecting the grand bailout and there's plenty of evidence that the grand bailout is coming one way or another. We have the new GCI for the World Bank. We have Japan talking about recycling funds. We have requests that probably will be made this year for new resources for the IMF and the InterAmerican Development Bank. Why should Citicorp reduce its exposure right now before it finds out whether all that money isn't going to be used to pay interest to them for the next 10 or 15 years?

So one of the reasons we're not going to get action is we're not going to get action until we define very clearly that this is not going to be at the expense of the taxpayer, that the big banks have to participate, that everybody has to share in the process of bringing this debt burden down.

INTERNATIONAL DEBT FACILITY

The last part of my testimony is in support of a proposal that you, Mr. Chairman, made very early on and very presciently I think history will judge, and that is for an international debt facility.

I think that this is an inevitability actually. We are going in that direction because it makes so much sense and I don't think that there's any way to stop it.

There are several myths about such a facility and I try to take on these myths at the end of my testimony.

The first myth is that it's a bailout of the banks and that's silly. What we are doing now is bailing out the banks by not having them take losses on these bad debts. What a facility would do is require them to recognize their losses. So that's hardly a bailout of the banks.

A second myth is that it's too costly for the taxpayers. That again is exactly opposite of the truth. If these countries have too much debt and they owe some to the taxpayers and some to the banks, if our policy is to keep the banks whole, who is going to end up bearing the bulk of the burden? That's the taxpayer. We see that happening right now. The Paris Club doesn't take any money from these countries any more. The Paris Club gives 100 percent rescheduling of principal and interest. The World Bank moves in money so that these countries can pay interest. The IMF moves in money so that these countries can pay interest back to the commercial banks. That's why the Wall Street Journal all of a sudden is such a devotee of Argentina and then attacking the IMF—how dare the IMF hold back its money from Argentina. The reason they care is that the IMF money will be recycled to pay interest to the commercial banks.

So contrary to being a taxpayer bailout, an international debt facility would be the very mechanism to get the commercial banks to accept some responsibility for the loans that they made on commercial terms with commercial risks at the end of the 1970's that didn't pan out very well.

The third myth is that somehow this would violate the case-by-case approach and that's silly because, of course, the relief would have to be designed on a case-by-case approach. We don't have case-by-case now. Is it really case-by-case that Argentina, Brazil, and Mexico each get exactly 13/16ths over LIBOR on their spread? Is that case-by-case? No. It's the opposite of case-by-case. Case-by-case would recognize that Argentina can bear 3 percent interest or 4 percent interest not 13/16ths over LIBOR. What we have is exactly the opposite. No precedents, no real differentiation. An international debt facility would allow us to have that differentiation.

A fourth myth is that an international debt facility would be inimical to new lending and this I think that Senator Gramm on his experience in the real world would agree that the best way to get new lending going to someone who has a debt overhang is to reduce the debt burden. And that's the essential philosophy of chapter XI. It's the essential philosophy of all bankruptcy codes at all times in all parts of the world. To get new lending to a borrower, you've got to get rid of the old overhang and the idea that reducing the debt through an international debt facility is somehow inimical to new lending gets it exactly backward in terms of the normal economics of financial distress.

Finally, an issue that I think is very important and I hope we come back to in questions is one that Senator Gramm raised about whether debt reduction would be inimical to reform. Here, I feel extraordinarily strongly that debt reduction is the best mechanism to spur reform in Latin America and give desperately needed political support to centrist political forces in a region which is torn apart by poverty, by economic distress, by social upheaval, and by ideological extremism of all sorts. We've got to give support to governments that are on the path of reform and I'd love to have a dialog in the question and answer with Senator Gramm to go through a number of countries that are doing remarkable things and the problem isn't at all their incentive to do it—and I cite Mexico as an example or Bolivia where I've been working for the past 3 years. It's not a problem of the incentives; it's a problem of can people whose policies we support stay in power? It comes down simply to that. Can they win elections? Can they defeat general strikes in the street? Can they prevent internal insurrection? It's not their will to do it. It's the fact that the capacity to govern in Latin America is extremely limited right now and this is a major mechanism to give support to those governments that are undertaking the right policies. I do not believe in blanket debt reduction. I believe that it comes after major reforms are implemented. But it is possible to identify governments that are carrying out major reforms.

When Mexico swings its noninterest deficits on the budget by 13 percent of GNP, which is three times the Gramm-Rudman targets for the United States over a period of 5 years, when the Mexican Government does that in 3 years, when it joins the GATT, when it liberalizes, and then when it's clear that this group in power right now has all the objectives that you have, Senator Gramm, about opening the economy and so forth, we've got to find ways to give them political support and that's what debt reduction is really all about.

So the idea of incentive for reform is really a more complicated issue and I would very strongly urge that we've got to give support to centrist political forces in Latin America right now as the only way that we're going to get the situation resolved.

[The complete prepared statement of Mr. Sachs follows:]

Subcommittee on International Finance and Monetary Policy
Senate Banking Committee

Professor Jeffrey D. Sachs
Department of Economics
Harvard University

February 8, 1989

I. Introduction

Mr. Chairman, and members of this committee, I am very pleased to be here to today to discuss the issue of developing country debt, at a time when the U.S. Administration is undertaking a review of policies in this area. This review is, of course, long overdue, as is painfully clear from the profound economic crisis and growing political instability in almost all of the democracies in Latin America.

Indeed, the need for such a review was already clear back in May 1986, almost three years ago, when I was asked to give testimony about the newly enunciated Baker Plan. At that time I stressed that[1]:

> By attempting to secure full interest servicing of interest on Latin American debt, the current strategy is: threatening democracies throughout the region; imposing an undue burden of adjustment on the debtor countries; hurting U.S. exporters by excessively squeezing import demands from the region; provoking high inflation and capital flight throughout Latin America; and, ironically, reducing the long-run value of the creditors' claims on the debtor countries, by discouraging adequate structural adjustments in the debtor countries.
>
> Peru is an example of a country in need of debt relief. The economy is in a state of collapse due to the combined pressures of falling export prices, fifteen years of poor economic management, and the heavy weight of debt servicing. Per capita GNP has declined by 15 percent since 1980, and real wages have fallen by an incredible 40 percent. The social fabric is crumbling. . .

> Where the strategy goes wrong is in its refusal to contemplate partial and selective debt forgiveness by private and official creditors in cases where the debtor country is crumbling under the weight of the debt burden, or where debt forgiveness might provide an important spur towards positive adjustment. It would be fatuous to destroy fragile democracies in order to collect the last cent on interest due to the commercial banks, particularly when much of the debt in Latin America is already written down in the books of the U.S. commercial banks, and in their stock market values, though almost none has been forgiven by the banks in their negotiations with the debtor country governments.

Mr. Chairman, these thoughts continue to apply today, with even more urgency, though today the quotation should be altered to use the more felicitous expression "debt reduction" rather than "debt forgiveness". Not only has the market value of the debt declined precipitously, from a value of about 75 percent of par in 1986 to a value today of about 40 percent of par, but the economic and political situation in Latin America has become truly alarming.

Today's facts are broadly known. What appeared to me in May 1986 to be a risk of social collapse in Peru has now occurred: annualized inflation rates of recent months are no less than 30,000 percent; real GNP will likely fall by 15 to 25 percent in the 12 months from September 1988 to September 1989; and radical terrorism has come in full force to the urban centers of Peru. In Argentina, the infrastructure has collapsed so completely that blackouts are the daily norm in Buenos Aires, and the telephone system in parts of that great city typically break down during rainstorms. Brazil too is headed towards a hyperinflation, with inflation exceeding 2,000 percent, and with a sharp political lurch towards to the left. And in Mexico, the vaunted political stability provided for decades by the PRI is now at a point of collapse. For anyone that cares to look, that country is at risk in the next few years of a drift into open class warfare.

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[1] Testimony to the Subcommittee on International Trade, Senate Finance Committee, May 13, 1986, pp. 2-3.

Much of this was predictable, Mr. Chairman, and indeed was predicted. But our government's strategy was to ignore these trends, in order to give our commercial banks time to rebuild their capital base. Unpleasant facts in Latin America were simply buried by an unrelenting publicity barrage from the money-center banks that Latin American recovery was just around the corner, and by the message that Latin America's crisis resulted only from policy mistakes within Latin America and not from the heavy burden of debt combined with a collapse of primary commodities prices. From my perspective as a policy advisor in Latin America, I can report that is both dire and worsening.[2]

It must be appreciated how completely the debtor-creditor relations have broken down in the past two years. There is a tendency to focus only on the top three debtors (Argentina, Brazil, and Mexico), so let's begin instead with the other 39 countries engaged in commercial bank debt restructurings. For these other 39 countries, there was not a single penny of new bank lending during 1987-88 in the so-called "new money" packages widely advertised under the Baker Plan.[3] There were two attempts to put together very modest (and very inadequate) "new money" packages, for Ecuador and Ivory Coast. Both attempts failed. More than a dozen countries are in long-standing open arrears, including Bolivia, Costa Rica, Dominican Republic, Ecuador, Honduras, and Peru in Latin America.

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[2] In addition to my academic research on the debt crisis at Harvard University and the National Bureau of Economic Research, I am an advisor to the United Nations Development Program, currently working in Bolivia, Ecuador, and Venezuela.

[3] The term "new money" package is itself a misnomer, since the "new money" is always less than the interest due. These lending packages to refinance part of the interest due are also known as "concerted lending" programs.

For the larger countries, Argentina is deeply in arrears to the banks, and will only get out of arrears if it is bailed out in the next month or two by the IMF and the World Bank.[4] The Brazilian new money package signed last September, and widely touted by the banks, is on the verge of breakdown after only three months, as that economy races towards hyperinflation.

Mercifully, the process of rebuilding the banks' capital base relative to Latin American exposure is now complete. This point was driven home a few weeks ago by Mr. William Seidman, Chairman of the FDIC, in testimony to the House Banking Committee[5]:

> Moreover, even in what surely could be considered a worst-case scenario, each of the nine money-center banks could write-off 100 percent of their outstanding loans to these six [largest debtor] countries and, on an after-tax basis, each of these banks would remain solvent. (emphasis in original)

This basic fact is underscored further by the all-time record profits of the U.S. money-center banks in the fourth quarter of 1988.

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[4] To its enormous credit, the IMF is resisting signing a phony deal with Argentina for the sole purpose of bailing out the banks. The IMF is attempting to maintain real standards of conditionality vis-a-vis Argentina. For this stance, the IMF is taking a lot of heat from the banking community (and friends at the Wall Street Journal), who see the IMF as a ready source of credit that Argentina could use to pay commercial bank interest. Argentina desperately needs real debt reduction (as President Alfonsin has repeatedly stated), not merely a new IMF program that can be recycled into commercial bank interest payments.

[5] Testimony of Mr. L. William Seidman to the Committee on Banking, Finance and Urban Affairs, United States House of Representatives, January 5, 1989.

Debt reduction is now an economic imperative for Latin America, and a foreign policy imperative for the United States. In fact, significant debt reduction is now emphatically in the long-term interests of the banks themselves, since debt reduction will improve the economic performance of the debtor countries and thereby the ultimate value of repayments that the banks will receive. The problem is that even though extensive debt reduction is in the collective interests of the banks, it will not occur by itself, for the same reason that bankruptcy can't occur without bankruptcy law and bankruptcy courts. Debt reduction, like bankruptcy, needs an institutional setting to bring it about. Otherwise, the individual interests of particular banks come to dominate the collective interests of all of the parties in this crisis.

It is not hard to envision the proper institutional setting: an International Debt Facility (IDF), under the official supervision of the IMF and the World Bank, to intermediate the process of debt reduction. Mr. Chairman, I believe that you were the first in the U.S. Senate to call for such a facility, and time has greatly bolstered the case for such a policy. This policy proposal is now widely admired and supported, not only in the Omnibus Trade Act of 1988, but also in related variants by the Japanese and French Governments, leading commercial banks such as the American Express Bank, and the debtor countries themselves, in the recent declarations of the Group of Eight democracies in Latin America.

In my judgment, this policy initiative is now close to being

implemented, as long as policymakers in the creditor and debtor countries keep their eyes on fundamental issues, and do not get distracted by the phony importunings of a few money-center banks. A few of the largest banks continue to pin their hopes on a mix of official bailouts (through increased IMF, World Bank, and Japanese lending), debt-equity swaps (despite their profound damage to the debtor countries), and debt relief granted by the smaller banks. This wish list of the largest banks is sometimes sold under the heading of "voluntary" debt reduction, which I will argue, holds as much chance for long-term success as "voluntary" bankruptcy.

The debt facility proposal is typically attacked along several well-rehearsed lines, none of which withstands scrutiny. It is said that the facility would be: (1) a bailout of the banks; (2) too costly for the taxpayers; (3) an abandonment of the case-by-case approach; (4) inimical to policy reform in Latin America; (5) harmful to the restoration of new private lending to Latin America; and (6) administratively unfeasible. I will urge later that all of these lines of criticism are unfounded, and are often based on a serious misreading of the debt facility proposal.

The remainder of my testimony will focus on two central themes. First, I will try to expose the profound shortcomings of so-called "voluntary debt reduction" schemes, as now supported by the commercial banks, and as championed for example in the recent statement of the Institute of International Finance on "The Way Forward for Middle-Income Countries". Second, I will outline the strong case for a debt facility, and try to clear away much of the underbrush of misunderstanding that has slowed the adoption of this proposal.

II. The Illusion of Voluntary Debt Reduction[6]

It is now widely recognized that the overhang of sovereign debt is imposing major costs not only on debtors but also on creditors, by seriously disrupting the debtor economies. The costs of the debt overhang, combined with the recovery of the commercial banks, have led to a widespread acceptance of the need for a process of debt reduction, by the World Bank and others. The major commercial banks have, in rhetoric at least, started to advocate debt reduction as one step out of the current crisis.

While the banks advertise "more than $26 billion" of debt reduction,[7] the form of debt reduction has been almost uniformally of the wrong sort, and indeed inimical to the process of recovery in Latin America. The vast bulk of this amount is private sector conversions (approximately $8.0 billion), and debt-equity swaps and local conversions (approximately $16 billion), versus only about $2 billion of debt buybacks and exit bonds for public sector debt. Unfortunately, these measures have done little to reduce the public sector debt, where the crisis lies, and the debt-equity swaps have in fact done much to fuel inflation in the region.[8]

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[6] This section draws upon a more extensive study of debt reduction mechanisms, "Efficient Debt Reduction", presented at the World Bank Symposium on Dealing with the Debt Crisis", January 26-27, 1989.

[7] See the Institute of International Finance, op.cit., p. 21.

[8] See "Efficient Debt Reduction", pp.36-39 for a detailed critique of debt-equity swaps.

Debt reduction schemes should be measured against the standard of restored creditworthiness of the debtor country. Specifically, the debt reduction should be extensive enough to accomplish the following goals: (1) to allow the debtor country to service the external debt on the revised contractual basis without the need to refinance interest payments in new concerted lending packages; (2) to allow the private sector in the debtor country to attract suppliers credits, trade credits, and project finance, on a decentralized basis. By this standard, "voluntary" schemes will not come close to solving the current problems. Under the current incentives, voluntary debt relief is bound to mean no more than a continuing nibbling away at the edges of the debt overhang, without real relief for the debtor or real benefits for the creditors. We need instead a much more ambitious program of "concerted" debt reduction, in which all of the creditor banks, on an equal basis, participate in debt reduction.[9]

There are several barriers to adequate debt reduction through

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[9] By "voluntary" debt reduction, it is usually meant that each bank should be able to decide whether to participate in a debt reduction scheme (e.g. each bank chooses whether to accept a given exit bond in a swap for the existing debt). In contrast, with "concerted" reduction, all of the banks jointly participate in debt reduction on an equal basis. It has long been recognized that in the case of new money packages, or commercial bankruptcy, a "concerted" arrangement rather than a "voluntary" arrangement is needed. The same is true with respect to debt reduction for the developing countries.

A simple mechanism exists to bring about concerted debt reduction: interest rates on the existing debts should be renegotiated to sub-market rates, in line with an assessment of the country's ability to pay. The reduced interest payments should then be partially or fully guaranteed by official creditors. This mechanism could be managed on a country-by-country case by a new international debt facility, under the auspices of the IMF and the World Bank, as is described later in the testimony.

"voluntary" means (e.g. buybacks, exit bonds, and debt-equity swaps). These barriers are: (1) the inherent collective-action barrier to comprehensive debt reduction; (2) the problem of precedents; (3) the problem of public sector bailouts; (4) the distorted incentives of the large banks; (5) the structure of the bargaining cycle.

Collective Action Barrier

Consider first the collective action barrier. There is a fundamental paradox with "voluntary" schemes. If the scheme is effective enough to restore creditworthiness, then each bank should hold on to its original claims, which will rise in market value (back to par) as the other banks give the relief. Thus, each bank has the strong incentive to hold back from such schemes, letting the other banks give up their claims.

The fundamental distortion of voluntary debt reduction schemes is recognized by the banks, even though they fail to understand its implications for the failure of the voluntary approach. The IIF has recently written that "the cost [of debt reduction] is the discount incurred in exchanging old assets for new assets, but the benefits accrue to all creditors and to the debtor country because its external debt servicing costs are reduced. Thus, particular creditors benefit if other creditors can be induced to reduce their claims." This externality is praised by the IIF as an added benefit of voluntary debt reduction, rather than as the profound barrier to efficient debt reduction that it is in fact.

The problem of precedent

Among the banks and the U.S. Treasury, almost the entire debt process is conceived of in terms of no more than five countries: Argentina, Brazil, Mexico, the Philippines, and Venezuela. While there are at least 42 countries that have rescheduled their commercial bank debts in recent years, the five main debtors account for about 80 percent of the exposure of the nine money-center U.S. banks to all 42 countries! The top three countries (Argentina, Brazil, and Mexico) alone count for 64 percent of the total exposure of the money-center banks to the problem LDCs. Importantly, however, from a humanitarian and geopolitical point of view, the five countries count for only 40 percent of the population of the entire group. In the debt management process, there has been little serious attempt to address the problems of the smaller debtor countries for fear of setting adverse precedents for the larger countries.[10]

The expectation of public sector bailouts

The third major reason why comprehensive debt reduction is unlikely is the continuing signal from the official community that public money will come to the rescue of the faltering renegotiation process. To the extent that the banks limit new lending or debt reduction, they know that the official community will make up at least part of the difference in official lending to the debtor countries. This is because the official creditors have an important stake in maintaining political and economic stability in the debtor countries, and thus are willing to put money into the process if the banks do not.

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[10] Countries such as Bolivia, Dominican Republic, Ecuador, and Peru, among others, cannot pay their bills, and are in no condition to expect a return to commercial bank landing for general balance of payments support for many, many years to come. And yet for these countries, as much as for Argentina, Brazil, and Mexico, comprehensive debt reduction has been off the agenda.

This infusion of public money acts as a tax on debt reduction schemes, because it reduces the incentives of the banks to agree to debt reduction schemes. The process of public sector bailouts is increasingly evident, as I have shown elsewhere.[11]

The distorted incentives of the large banks

Despite all of the biases against debt reduction (e.g. the advantages of waiting for others to give relief; the problems of precedent; the prospects of an official bailout), most banks are now prepared to accept significant losses on the debt in return for ridding themselves of the problem. This is evidenced by the fact that the regional U.S. banks are now divesting of their entire LDC debt portfolios on the secondary market at a remarkable rate, with losses reaching 30-60 percent of the face value of the portfolios. It is a few money center banks, not the vast bulk of small and medium size U.S. banks, that are resisting comprehensive writedowns of their portfolios. Note in Table 2 that while most

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[11] See "New Approaches to the Latin American Debt Crisis", Harvard University, September 1988.

U.S. banks are reducing their exposure, the non-money center banks are reducing their exposure at a much faster rate.

It is important to analyze why the large banks are less willing to sell off their portfolios, since that also helps to explain why the large banks have so vigorously resisted concerted debt reduction arrangements. There are basically three reasons for the resistance of the largest banks. First, the large banks are resistant to writedowns because of the greater LDC exposure relative to capital. This matter can be handled, however, through appropriate regulatory policies in support of comprehensive debt reduction arrangements.[12] Second, the large banks have superior

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The key point is that regulatory oversight of the banks is based on the book values, not market values, of the banks' assets and liabilities. This means that heavily exposed banks may sometimes have the incentive to avoid book losses on their portfolio even if they represent market gains. A bank with a large exposure of LDC debt relative to bank capital might satisfy capital-adequacy requirements when measured at book values, but fail to satisfy them when measured at market value. In this case, the bank might turn down participation in a debt reduction scheme, even if it raises the market value of the LDC exposure, if at the same time it causes a book loss on the bank's claims that pushes the bank out of compliance with the regulatory guidelines on capital adequacy.

This kind of distortion arises because of faulty accounting procedures. In the U.S., the banks are not required to mark-to-market the valuation of LDC claims, so that the vast bulk of the claims is kept on the books at 100 percent of face value, despite a secondary market value of around 40 percent of face value. Banks are willing to absorb some losses on their LDC claims in order to clean up their portfolios, but only if such losses do not jeopardize the bank's plans for meeting the guidelines on capital adequacy, which are based purely on book values.

The solution to this problem is to require banks to mark their exposure to market, at least for those banks that refuse to participate in a comprehensive debt reduction scheme. For participating banks, the regulatory authorities can exercise forebearance, and allow for gradual writeoffs over a period of several years.

access to debt-equity swaps than do the small banks. In general, these debt-equity swaps offer a less costly way of divesting debt than does the secondary market. Thus, the big banks resist comprehensive agreements in order to maintain their options to pursue debt-equity swaps. Unfortunately, from the point of view of the debtor country, the debt-equity swaps tend to be highly deleterious.

Third, the large banks recognize that by slowing their own debt reduction process, they also gain by having the smaller banks "cash in", and accept losses via exit bonds, secondary market sales, and so forth. Since any creditor is made better off if another creditor voluntarily makes a concession to the debtor (since the remaining debt increases in value), the large banks have an added incentive to let the small banks get out at a large loss. John Reed, Chairman of Citicorp, was quite explicit on this point in a recent speech:

> What is happening right now is that some banks, like our own, are converting debt into long-term investments [i.e. debt-equity swaps]. At the same time, some smaller banks that have very different interests are selling out at prices that, frankly, are quite convenient to those of us who are going to stay in for the long haul, and quite convenient for the countries. (emphasis added).[13]

The waiting game imposes costs on the creditors as a whole (by allowing a continuing economic deterioration in the debtor countries), but these costs are borne by the smaller banks (who

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[13] See John S. Reed, "Opportunities for the New Administration", remarks at the National Foreign Trade Council, New York, New York (October 18, 1988) and the Los Angeles World Affairs Council, Los Angeles, California (October 27, 1988).

sell their debts at exceptionally discounted prices), not by the larger banks which impose the obstacles to concerted debt reduction.

III. The International Debt Facility

The voluntary approach, at least as now conceived, is unlikely to succeed in its central purpose: to restore the creditworthiness of the debtor countries in order that they may achieve renewed growth and political stability. Debt reduction should be comprehensive to achieve this goal, and for that we need a new approach. A real debt settlement requires the concerted participation of the banks. To the extent that there remains a "menu of options" for the banks, this menu should only include alternative ways of accomplishing debt reduction. In other words, banks should not have the luxury of opting out of the debt reduction process entirely, for that frustrates the whole process.

The simplest way to achieve a comprehensive reduction of debt is through a reduction of interest rates to sub-market levels on the existing debt. This mechanism is nearly ideal: it is administratively straightforward (the contracts merely have to be rewritten to include interest rates of, say, a fixed 4 percent, rather than LIBOR plus 13/16); it is comprehensive; it is equitable in its impact across banks; it avoids the adverse consequences of debt-equity swaps; it is a standard mechanism for debt workouts in the domestic context; and it may even obviate the need for large, immediate writedowns of capital under U.S. banking regulations.[14] Furthermore, it is easy to combine interest rate relief with credit enhancement, since the reduced interest rates can be guaranteed by the official creditors, e.g. the World Bank, as part of the restructuring process.

Achieving a comprehensive debt reduction for a particular debtor country will require several steps on the part of the official creditor community (especially the IMF and World Bank):

1. An explicit recognition by the IMF and World Bank that the debt burden of the country should be permanently reduced (conditional on the commitment of the debtor country to pursue appropriate macroeconomic policies);

2. An official policy that the banks should share *equally* in the debt reduction. A "menu of options" may still be used in recognition of regulatory differences facing different banks, but in economic terms, all banks should participate equally in the debt reduction mechanism.[15]

3. An official policy against debt-equity swaps as a significant component in debt reduction, except for the handling of private sector debt or the case of privatisation of a public-sector firm.

4. The design of official lending programs (e.g. standby programs and structural adjustment lending) based on debt-servicing targets that take into account the necessary debt reduction.[16]

5. An official policy that IMF and World Bank programs can go forward despite arrears to the commercial banks in circumstances in which the IMF determines that the debt should be reduced, but in which the banks have not yet agreed to a comprehensive debt reduction mechanism.

6. Regulatory support for debt reduction, with regulators requiring writedowns of debt to market values for those countries for which debt reduction packages are not concluded. At the same time, a stretching out of writedowns in the cases that comprehensive debt agreements are reached.

7. The use of official money to "enhance" the interest stream of debt for cases in which the countries and the commercial banks have agreed to a comprehensive debt reduction scheme. The official institutions can provide partial or complete interest payment guarantees, depending on the precise economic circumstances of the debtor country, and the nature of the debt reduction agreed to with the commercial banks.

8. Strict conditionality on official lending for all countries negotiating debt reduction programs, and for all countries seeking programs in the face of commercial bank arrears.

9. A policy that sustained interest arrearages on payments *after* debt reduction has taken place should trigger cross-default provisions with other IMF and World Bank lending. This is especially important in cases in which there are official guarantees of the interest payments that have been missed.

10. An official policy of support for debt reduction through the mechanism of *sub-market interest rates*, as the simplest, fairest, and administratively easiest form of comprehensive debt reduction.

These steps could best be accomplished in the context of an international debt facility, that would be in charge of: (1) organizing the comprehensive package; (2) linking the debt reduction package to policy reforms in the debtor country; and

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[14] Under FASB 15, a debt restructuring which preserves principal, but which reduces interest rates, does not in general require a capital writedown.

[15] As an example, some banks might prefer to take debt reduction by a cut in principal, while others would prefer to maintain principal while accepting a sub-market interest rate level. These differences should be accomodated in a menu of options, but all banks should be required to choose among the menu. New money, or longer maturities and grace periods, definitely *should not* be equated to debt reduction in the menu.

[16] In other words, if a country has a huge overhang of debt, the IMF and World Bank programs for the country should be designed on the assumption that the debt will eventually be reduced in negotiations between the debtor and the banks.

(3) providing official guarantees on the reduced interest payments that are due after the debt reduction package is put into operation.

This solution, which is quite straightforward, is often opposed on misleading grounds. Let me conclude my testimony by touching briefly on several of the "myths" surrounding an international debt facility.

Myth 1. A debt facility is a taxpayer-financed bank bailout

This is real whopper. A debt facility is the most effective and orderly way for insuring that the banks accept losses on their bad loans, rather than pawning them off onto the taxpayer via new lending from the IMF, World Bank, and creditor governments. A debt facility would require a concerted acceptance of bank losses for the first time in this crisis.

Myth 2. A debt facility is too costly for the taxpayer

This, no doubt, is the preeminent myth that has forestalled any action on the proposal. With the popular press fond of quoting a developing country indebtedness of more than $1 trillion, opponents of the debt facility are able to instill the notion that real relief would require hundreds of billions of dollars of taxpayer funds.

This is wrong on several points of view. The target of the facility is medium-and-long-term debt of the public sector of troubled debtor countries. This amounts to about $240 billion,

with a secondary market value of the debt of about $90 billion. Other kinds of debt (e.g. debt owed to the IMF, World Bank; short-term debt; debt owed by the private sector; etc.) would not be part of the plan. Moreover, it is the banks, not the taxpayer that would assume the bulk of the losses under the debt facility. Roughly speaking, the debt would be cut from approximately $240 billion to $90 billion (in steps, and assuming that all countries eventually qualify for debt reduction, by undertaking adequate adjustment programs). The facility would guarantee the payments of part or all of the $90 billion due. The taxpayers would be liable only if the debtor countries could not manage to carry the burden of the $90 billion, and would be liable only for that part which remains unpaid by the debtor countries.

The U.S. share of the guarantees could be quite modest. In another detailed study, I have illustrated the very small amounts at stake by assuming that the Japanese would cover one-third of the guarantees, and the U.S. would cover one-fourth.[17] The result is that the U.S. ends up guaranteeing about $22.5 billion in liabilities of the facility. If paid-in capital is about 10 percent of the amount of the guarantees, the U.S. contribution would come to approximately $2.3 billion. This could be distributed over five years, with an annual budgetary burden of about $470 million.

Thus, for somewhat less than each year's foreign aid disbursement to El Salvador, the U.S. would be able to fund its participation in an international debt facility that could effectively solve the commercial bank debt crisis for the 30 largest debtor countries. This comparison should certainly put in perspective the very modest sums involved!

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[17] See "New Approaches to the Latin American Debt Crisis", Harvard University, mimeo, September 1988.

If the political will is still stuck, then the Committee might reflect on the fact that the $90 billion of secondary market value of the developing country debt is equal in value to about 60 acres of land in downtown Tokyo. A modest sale of Japan National Railway land holdings in Tokyo could readily finance the entire international debt facility. (And remember, the cost to Japan is not the price of the debt that is guaranteed, but only the cost of the guarantees if some of the reduced payments are not met).

Myth 3. A Debt Facility is contrary to the Case-by-Case Approach

This myth reflects a simple misunderstanding. Advocates of a debt facility do not advocate an across-the-board writedown of debt. Rather, comprehensive debt reduction would be available on a case-by-case basis, depending on the willingness of the country to undertake economic reforms. In each case, the extent of reform would be tailored to the economic needs of the country in question. Those needs could be ascertained based on a professional assessment of the weight of the debt burden, the solvency of the public sector, the extent of past losses in GNP as indicative of the growth potential of the economy, and so

forth.

It might turn out that only a few countries would qualify for debt reduction supported by the debt facility. But at least the option would be universally available for all debtor governments that are willing to attempt a program of economic reform.

Myth 4. The Debt Facility is Inimical to Economic Reform

This notion is simply backward. The debt overhang itself is the greatest barrier to economic reform, because it destabilizes governments in Latin America, and thereby deprives governments of the political base to pursue sustained programs of reform. Moreover, it is virtually impossible to sell a program of economic reform in Latin America today, because the political opposition is only too quick to point out that under current arrangements, the benefits of reform accrue to the international banks, rather than to the domestic citizenry.

Two countries, Bolivia and Costa Rica have already achieved a measure of de facto debt relief. These two governments have, indeed, among the most successful programs of reform now underway in the region in large part because of the breathing space offered by the easier terms on debt servicing.

The real harm with the current policies is that politicians friendly to the United States in the region will find themselves increasingly undermined by opponents who attack the U.S. (and the rest of the creditor world) as the agents of oppressive debt collection.

Myth 5. Debt Reduction would be harmful to new lending

The banks have long argued that Latin America should be drained of approximately 5 percent of GNP per year in net interest payments, since to give relief would somehow restrict the access of the countries to "new lending". Since no real net lending is in fact available, the point has always seemed to me to be unreal in the extreme.

But more fundamentally, there is an enormous confusion about the linkage of debt reduction and new lending. In bankruptcy, for example, the reduction of debt is seen as *vital* to *restoring* creditworthiness. It is common in a bankruptcy action that once the existing debts are reduced, the bankrupt firm may *immediately* return to the credit markets for new financing based on a cleaned-up balance sheet. Similarly with sovereign debt, it is the debt overhang itself that prevents the return of the sovereign to the loan market, and the most effective way to *revive* lending for trade financing and fixed capital formation is to reduce the debt burden to a level that can be serviced by the debtor.

Those who argue against debt reduction because of an alleged adverse effect on future lending confuse the effects of two kinds of actions on the debt. A unilateral and hostile suspension of payments by a debtor may indeed delay the debtor's return to the

capital markets.[18] Contrariwise, an agreed and negotiated reduction of debt can *speed* the return of the sovereign to the capital market. Note, for example, that Indonesia had access to commercial market borrowing just four years after Indonesia's debts to foreign governments were substantially reduced in 1970. The alleged reputational onus against a government that failed to honor its debts simply did not exist in this case. If the creditor banks are truly worried about a sovereign's future access to lending, then the banks should strive to reduce the debt burden via negotiation, rather than cornering the debtor into the need for unilateral actions.

Myth 6. The Debt Facility is Administratively Unfeasible

A final myth is that the debt facility is unworkable because the banks might choose not to participate. And if the debt facility enters the secondary debt market to try to buy up the debt, the price will be driven too high to make a debt repurchase feasible. Once again, this myth reflects an enormous naivete over the actual workings of the loan market. The debt facility would not "go into the market" to buy debt. Instead, the banks as group (negotiating via the steering committee) would have to reach a comprehensive agreement with the country in order to qualify for assistance from the debt facility.

Since the major banks hold most of the debt, and since the vast majority of the banks would be only too happy to be relieved of their exposure in an organized manner, the debt facility can be made to work with the cooperation of a very small number of U.S. banks, including Citibank, Bank of America, Chase Manhattan, Chemical Bank, and Morgan. There are many carrots and sticks to induce participation, including regulatory changes, official guarantees, support from the IMF and the World Bank, etc. Moreover, it is highly unlikely that any of these banks would stand in the way of a reasonable settlement at risk of interfering with a matter of significant foreign policy concern of the United States.

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[18] It may still make sense as a measure of last resort, however.

Unanimity would not be required, moreover, since under the existing bank agreements, qualified majorities may change the terms of lending agreements for the entire group of creditors. David Finch, a long-time senior manager of the IMF, and one of the wisest observers of the debt issue in the world, has summarized the question of participation as follows: ". . . there is no question that the creditor governments have it in their power to give substantive legal protection to a majority settlement".[19]

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[19] See C. David Finch, "IMF -- The Record and the Prospect", Institute of International Economics, Washington D.C., mimeo, 12-10-88.

Table 2

Reductions in LDC Exposure at 29 Banks Selected Among the Largest

	Total LDC Exposure in Millions (unless otherwise noted)		Exposure Reductions June 1987 to September 1988	
	June 87	Sept 88		
Citicorp	$14,600	$12,100	$2,500	17%
BankAmerica	10,354	9,000	1,354	13%
Manufacturers Hanover	9,234	8,688	546	6%
Chase Manhattan	8,740	7,950	790	9%
Chemical Banking	5,945	5,900	45	1%
J.P. Morgan	5,400	4,700	700	13%
Bankers Trust	4,000	4,000	0	0%
First Chicago	3,120	2,429	691	22%
Continental Illinois	2,400	2,000	400	17%
Irving Bank Corp	1,950	1,890	60	3%
Mellon	1,600	1,386	214	13%
Security Pacific	2,200	1,260	940	43%
Bank of Boston	1,400	1,000	400	29%
First Interstate	1,606	996	610	38%
Wells Fargo	1,909	760	1,149	60%
Bank of New York (a)	544	470	74	14%
Republic of New York	487 E	461 E	26	5%
PNC Financial (c)	481 E	291	190	40%
First Fidelity (b)	237	177	60	25%
Northern Trust (a)	321	149	172	54%
Southeast Banking (b)	215	117	98	46%
MNC Financial	223	107	116	52%
Bank of New England	307	106	201	65%
Valley National	155	62	93	60%
Fleet/Norstar	145	52	93	64%
First Wisconsin	289	17	272	94%
Norwest Corp. (b)	515	16	499	97%
First Wachovia	212	8 (d)	204	96%
NCNB Corp.	247	4	243	98%
	$78,837	$66,095	$12,742	16%

(a) Includes loans only
(b) Includes non-trade-related credits only
(c) Includes medium- and long-term LDC loans only
(d) The exposure totals at these dates were fully reserved against

NOTE: Exposures only in dollars (and not in local currency) are included
E - Estimate

Senator **Sarbanes**. Thank you.
Professor Hanke.

STATEMENT OF STEVEN HANKE, PROFESSOR OF APPLIED ECONOMICS, JOHNS HOPKINS UNIVERSITY, BALTIMORE, MD

Mr. **Hanke**. Thank you, Mr. Chairman.

Let me start by really in effect answering Senator Graham's question asked at the end of the last panel. He was asking about what criteria you would look at if you were gauging success or failure in the LDC context. And I think most economists would agree that the following conditions have to be approximated before you can sustain economic growth.

CONDITIONS TO SUSTAIN ECONOMIC GROWTH

One, is to keep budget deficits and government spending under adequate control.

Two, is to keep inflationary pressures under reasonable control and roughly approximating the world average.

Three, is to take advantage of international trade and institute liberal trade policies and reforms.

Four, is to avoid excessive tax rates.

Five, is to avoid excessive use of subsidies and tax incentives to encourage particular types of activity—in short, avoid industrial policy.

Six, is to avoid the manipulation and repression of private capital markets.

Seven, is to avoid undue union power. In other words, state creative monopoly rights and privileges for unions should be avoided.

Eight, is to avoid price controls.

Nine, is to avoid market intervention and restrictions on competition of any kind.

Ten, is to avoid state-owned enterprises.

And eleven, is to avoid unclear boundaries between the public and private sector and in particular avoid bailing out private firms who go bankrupt. They should be allowed to go bankrupt. This is a typical kind of boundary problem I'm referring to.

Now to approximate the conditions for sustained economic growth, liberal or laissez faire economic policies must be adopted. If this occurs, the policies will bear fruit even when external indebtedness is relatively high.

For example, let's take the case of Chile. This country has put in place liberal economic policies that have established the conditions for sustained economic growth that I just reviewed. Some of the more important policies are reviewed in a paper that I authored with Prof. Rolf Luders, who formerly served as Chile's Minister of Finance and Minister of Economics. Mr. Chairman, I have taken the liberty to include this paper with my testimony and would request that it be included in the record.

In consequence of approximating the conditions for sustained economic growth, Chile's economy has continued to register a marked improvement. In 1988 it turned in an outstanding performance, particularly when compared with other Latin American countries. For example, its real GNP growth was up to about 5.5

percent, inflation was down to 12 percent, unemployment was down to 7.5 percent, central government expenditures as a percent of GNP were down to 24 percent, fiscal deficit as a percent of GNP were less than 1 percent, exports were up to $6.2 billion which was 31 percent of GNP, a trade surplus of $1.6 billion was registered, and private savings were running at 24 percent of GNP.

This economic performance was recorded while Chile was still carrying a heavy external debt load. However, it is important to mention that this indebtedness has been coming down in absolute terms. As was mentioned earlier, it's come down roughly about 30 percent. This has been facilitated in part because Chile has instituted an innovative debt swap program. The swap program was instituted in 1985, one of the earliest ones, is one of the most innovative and aggressive.

DEBT FOR EQUITY SWAPS

Three points are worth mentioning with regard to swaps and in fact the criticism of swaps. First, many claim that swaps create inflation. This is not the case. Chile has brought down inflation while aggressively pursuing swaps. Inflation results from lack of monetary control and not swaps.

Second, many claim that debt for equity swaps are "bad" because foreigners increase their control of real assets in the countries that engage in them. I would simply point out that this is really a rather silly argument because the local countries have jurisdiction over all their real assets so that foreign investors are basically taking their assets, putting them in another jurisdiction that they don't have control over.

And third, many say that swaps don't generate new capital flows, that this capital would have gone in to the countries in any case. This has not been the case with Chile. With investor confidence, with the innovative swaps, there has been new money that's gone into the Chilean situation.

Now the Chilean case illustrates that if you have the proper liberal economic policies put in place a country can sustain sound economic growth and reduce its external debt simultaneously. The problem is that other Latin American countries show no propensity to adopt liberal economic policies and I beg to differ with Professor Sachs and Mr. Botero who spoke at the last panel. I in fact had cut out the same thing in the Wall Street Journal that Senator Gramm had indicated and read into the record earlier. In all those cases, from July 1985 until January 1989, the market discounted heavily and progressively discounted the debt in those countries. So the market certainly isn't giving them a green light or a star for economic reform and good performance.

So the root cause of the problem, to use the chairman's phrase in his opening remarks, is in fact that these countries are an economic mess and they need structural liberal reforms put in place and I don't even see any of the centrist politicians talking about this, unfortunately, in most of the countries.

INCENTIVES TO PRESS FOR REFORMS

The question is, how can you give them an incentive in these Latin countries to press for these reforms? I think one way that you could do it is through a mechanism of voluntary debt relief in which the countries would have an incentive to adopt liberal pro-growth policies that would be put in place in the following manner.

A debt relief committee would be set up. This committee would be comprised of impartial experts, including experts certainly outside the IMF and the World Bank. It wouldn't necessarily exclude members from there but it would be a wide-ranging impartial committee. It would function in the following way.

Each review period, perhaps a year, the committee would determine whether the debtor country was progressing or regressing. Progress or regression would be measured, for example, against 11 criteria for sustained economic growth that I previously mentioned. If there is progress in the review period, interest rates on outstanding debt would be reduced in the next period. If there was no progress, there would be no change. And if there was regression, rates would go back up. At the limit, they would go back up to the contracted original level and on the downside they could go down to zero.

Now this has important benefits—this process—because the benefits to the debtors would be that they would have an incentive to put in liberal economic policies and start growing and they would be able to afford to pay off principal on the debt even at the extreme case where they had been following the criteria properly and interest payments were completely done away with. They, in short, would be able to see some light at the end of the tunnel and I see I've got my red light on here.

Banks would benefit from this also because even at the extreme, if the interest rate was pushed down to zero, you would be in a situation similar to the following. If I loaned you $100 at zero interest rate and you amortized it over a 10-year period in equal payments, the present value of that if your discount rate was 10 percent would be about $68, which is higher than most of those debt valuations in the table that you went through, Senator Gramm. It also would obviously benefit the international economy because it would increase the level of economic activity and trade.

I think in closing let me just mention that the proposal that I've outlined for rewarding actual pro-growth performances is quite different than the so-called IMF conditionality. It has nothing to do with beating someone over the head and having them sign a letter which is really hardly worth the paper it's written on, and going ahead as you have done so in the past. This would actually look at real performance, monitor real performance, give someone relief, if in fact they perform and take the relief if they started going in the wrong direction.

Back again to the chairman's opening comment, this root cause of the problem, I would just like to close by emphasizing that the debt is not the root cause of the problem. The root cause of the problem is because the economies are in a horrible mess. They have irresponsible politicians that have not put in place liberalizing policies that could have opened the economies up and could have allowed them to perform in a way that was similar to what the performance of Chile has been over the past few years.

Thank you, Mr. Chairman.

[The complete prepared statement of Mr. Hanke follows:]

STATEMENT
ON
THE LDC DEBT
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
OF THE
SENATE BANKING COMMITTEE
OF THE
CONGRESS OF THE UNITED STATES

by

Steve H. Hanke

February 8, 1989

I am Steve H. Hanke, Professor of Applied Economics at The Johns Hopkins University in Baltimore and Chief Economist at Friedberg Commodity Management, Inc. in Toronto. Allow me to thank you for the opportunity to present some of my thoughts on the issue of LDC debt.

Conditions for Sustained Economic Growth

The economic objective in LDCs is to sustain rapid economic growth. To do this, most economists agree that the following conditions must be approximated:

(1) Keep Budget Deficits and Government Spending Under Adequate Control. Although budgets need not be balanced at all times, there are severe limits to the budget deficits that can be

incurred with relative impunity. Governments and politicians must learn to say no to spending requests, so that public spending, as a share of the economy, is kept at modest levels and so that large budget deficits aren't realized on a regular basis.

(2) Keep Inflationary Pressures Under Reasonable Control. To encourage economic development in small countries, the inflation rates should not exceed that realized in the world economy.

(3) Take Advantage of International Trade. Liberal trade policies facilitate the efficient allocation of resources and stimulate economic growth. This is particularly true in small economies, where real competition can only be obtained through liberal trade policies that allow foreign producers to compete freely in domestic markets.

(4) Avoid Excessive Tax Rates. Excessive tax levels and rates distort behavior and create large disincentives to economic activity, while yielding little revenue.

(5) Avoid Excessive Use of Subsidies and Tax Incentives. Subsidies and tax incentives, which are designed to achieve particular objectives, may or may not actually assist in obtaining those goals. However, one thing is certain: they distort economic choices, resource allocation and retard economic growth.

(6) Avoid the Manipulation and Repression of Private Capital Markets. The manipulation and repression of private capital markets distort and retard the savings-investment process. Hence, they should be avoided because they act as a drag on economic growth.

(7) Avoid Undue Union Power. State-created monopoly privileges for unions -- such as exclusive representation and compulsory union membership -- should be avoided. These monopoly privileges distort labor markets and create an artificial and unfair advantage over other non-union interests in democratic processes. In consequence, monopoly privileges for labor unions act as a drag on economic growth.

This lesson is not intended to imply that all unions (collective bargaining) are detrimental and inconsistent with free labor markets. For example, if unions aren't granted monopoly privileges, they can still represent their voluntary members in collective bargaining. In this case, workers are free to associate, or not to associate, with a labor union of their choice. Moreover, only those employees who exercise their right to join unions are bound by the collective agreements entered into by their unions. Employees who exercise their right not to join unions are free to negotiate their own wages, terms, and conditions of employment if employers are willing to contract with them individually. Unions that are organized along these voluntary lines (without state-created monopoly privileges) are perfectly consistent with free labor markets.

(8) Avoid Price Controls. Price controls can't be justified on economic grounds. They tend to vitiate the signalling role that prices should play. Hence, price controls impede the movement of resources from lower-valued to higher-valued uses, and result in resource misallocation and slower economic growth.

(9) Avoid Market Interventions and Restrictions on Competition. Market intervention and restrictions on competition result in inefficient enterprises, resource misallocation, and slow economic growth.

(10) Avoid State-Owned Enterprises. State-owned enterprises are inefficient and act as drags on an economy. For example, sales, adjusted profits and productivity per employee are lower for nationalized enterprises than for private firms. Also, taxes paid per employee are lower; sales per dollar of investment are lower; profits per dollar of assets are lower; per dollar of sales, wages plus operating costs are higher; sales grow at a slower rate; and, with few exceptions, state-owned enterprises, where proper accounts are presented properly, typically generate accounting losses.

(11) Avoid Unclear Boundaries Between Public and Private Activity. When boundaries between the public and private sector are unclear, it is symptomatic of poorly defined property rights. Ill defined property rights distort resource allocation and retard economic growth Government bailouts of bankrupt private firms are but one example of unclear boundaries between public and private activity.

Economic Growth Policies Bear Fruit

To approximate the conditions for sustained economic growth, liberal (laissez-faire) economic

policies must be adapted. If this occurs, these policies will bear fruit, even when external indebtedness is relatively high.

For example, let's take the case of Chile. This country has put in place liberal economic policies that have established the conditions for sustained economic growth. Some of the more important policies are reviewed in a paper that I authored with Professor Rolf Luders, who formerly served as Chile's Minister of Finance and Minister of Economics. I have taken the liberty to attach this paper to my testimony.

In consequence of approximating the conditions for sustained economic growth, Chile's economy has continued to register a marked improvement. In 1988 it turned in an outstanding performance, particularly when compared with other Latin American countries. For example, it's real GNP growth was up to about 5.5%, inflation was down to about 12%, unemployment was down to 7.5%, central government expenses as a percent of GNP were down to 24.3%, the fiscal deficit as a percent of GNP was only 0.8%, exports were up to $6.2 billion, and the trade surplus was up to $1.6 billion.

This economic performance was recorded while Chile was still carrying a heavy external debt load. However, it is important to mention that this indebtedness has been coming down in absolute terms. This has been facilitated not only by Chile's liberal economy and its economic performance, but also Chile's innovative swap program in which external debt can be swapped for Chilean equity or debt. Since the program was instituted in 1985, Chile's external debt has been reduced by almost 25%.

Three points are worth mentioning with regard to swaps. First, many claim that swaps create inflation. This is not the case. As long as the monetary authorities control the money supply, inflation will be held in check, with or without swaps. Chile is a good example of how monetary control has been accomplished and inflation brought down, with swaps.

Second, many claim that debt-for-equity swaps are "bad" because foreigners increase their control of real assets in the countries that engage in these swaps. This is a rather silly argument. Since countries have local jurisdiction over real assets within their boundaries, it is hard to see how foreigners are going to control assets in those countries. In fact, with debt-for-equity swaps, foreigners are moving their assets into an LDC which will now have jurisdiction over them.

Third, many also claim that swaps don't generate any new capital inflows to the countries that embrace swaps. Rather, they argue that the investments would have been made without swaps. This has not been the case in Chile, where new capital flows (in addition to those that would have normally been made) have been realized. With the Chilean liberal economic policies (and innovative swaps), investor confidence has been revived. This is very important. As Lord Keynes wrote in the General Theory: "the state of confidence, as they term it, is a matter to which practical men always pay the closest and most anxious attention." In consequence of renewed investor confidence, foreign capital, in the form of new money, has begun to pour into Chile. This, in part, has made the burden of external debt reduction less onerous.

Toward Voluntary Debt Relief

The Chilean case illustrates that, if the proper liberal economic policies are put in place, a country can sustain sound economic growth and reduce its external debt.

The problem is that other Latin American countries show no propensity to adopt liberal economic policies. In consequence, these countries are not moving toward satisfying the conditions for sustained economic growth, and needless to say, most are experiencing economic chaos.

We must, therefore, develop a program that gives LDC debtors an incentive to adopt the proper liberal economic policies. This can be done by instituting a program to promote voluntary debt relief. This program, which I will outline below, holds benefits for the creditors (banks) and the debtors (LDCs). Moreover, it does not require the use of U.S. taxpayers' money to bail out the banks.

The incentive to adopt liberal, pro-growth policies would be put into place in the following manner. The banks and the LDCs would voluntarily agree to be bound by the decision of a Debt Relief Committee. The Committee would be comprised of "impartial" experts. It would function as follows: in each review period (perhaps one year), the Committee would determine whether the debtor was progressing or regressing. Progress or regression would be measured, for example, against the eleven criteria for sustained economic growth that I previously mentioned. If there was progress in a review period, interest rates on outstanding debt would be reduced in the next period. If there was no progress in the review period, rates would not be changed for the next period. If regression was recorded in the review period, rates would be increased (with the upper limit being the contracted level). Under this program, good performances could result in relief which could, at the extreme, eliminate interest obligations.

It is important to emphasize that this proposed program is in sharp contrast to IMF conditionality in two important respects. First, it would be based on a pro-growth set of performance criteria. Second, actual performance would be monitored (forget letters of intent, which are hardly worth the paper on which they are written), and relief would be subject to real performance.

The debtors would benefit because:

(1) Most importantly, the program would give them an incentive (debt relief) to adopt liberal policies that would stimulate economic growth.

(2) In consequence, investor confidence would return and capital would begin to flow to promising investment projects.

(3) With the debt relief, economic growth and new capital inflows, the principal on outstanding loans could be repaid on an sustained basis.

(4) There would be light at the end of the tunnel, which would create a climate of optimism.

The banks would benefit because:

(1) They would have the prospect of having the market value of their assets (loans) increase. To appreciate this, assume that I loan you $100 at no interest, and that you amortize this loan in equal amounts over 10 years. At a 10% discount rate, the present value of the loan is $67.59. If you amortize the loan in equal amounts over 20 years, its present value would be $46.82. On a per dollar basis, either of these alternatives would look rather attractive to the banks that are presently holding much of the LDC paper.

The international economy would benefit because:

(1) Global economic activity and trade would increase.

Concluding Observation

The only means to reverse -- on a sustained basis and without taxpayer money -- the net resource flows from the LDCs to the developed countries, is for the LDCs to adopt liberal economic policies. The proposal that I have outlined, by rewarding actual pro-growth performances, will encourage these policy changes. If relief is not coupled with liberal economic reforms and pro-growth policies, then we will be doing nothing more than throwing good money after bad.

Senator **Sarbanes**. Gentlemen, thank you very much.

Senator Gramm has to leave and I'm going to defer to him for a few moments so he can put in some questioning and then I'll go to Senator Shelby and take my turn at the end.

Senator **Gramm**. Mr. Chairman, let me thank you for that and let me thank members of this panel. We have invited you here, as we did the other panel, to try to come to a better understanding of the problem.

I want to give most of the time I have to you, Professor Sachs, but let me just state several things that I've observed and then get your response in the context of what you were saying.

One of the things in listening to the previous panelists, especially Mr. Botero, is this idea, that I hear over and over again, relating to the Third World. It is the equivalent in economics to the slogan "No pain, no gain" in athletics or bodybuilding. That is the notion that if the policies of a government decimate the working people, then it is somehow an indication that that government is making a great effort.

I don't dispute for a moment that the policies of Mexico have been a disaster and that they have hurt working people. They have by and large not hurt owners or the people who are running parastatals. They have protected to a significant extent, though not totally, the political base, but they have been very painful policies.

I don't see a necessary relationship between pain and gain in economics.

Second, as concerned as I am about the budget deficit, if you look at developing countries there are other indications of even worse performance. We focus on things like the deficit as an impediment to our growth, but when you don't have protection of private property, when you have limitations on the ability to trade, barter and exchange, when you have prohibitions on foreign ownership that restrict your ability to attract capital, and when you have people working in maquiladora plants producing batteries to sell on the world market but you don't let them buy the batteries they produce or you force them to pay twice as much for batteries that last half as long, the deficit is not the primary economic indicator there that it is here today.

So I personally believe that if we could find a way to induce the reforms that Professor Hanke is talking about, and we could entice governments to do those things, that it would be something that I would be willing to look at and support. I really believe if the Government did those things they wouldn't need our help. I believe even Mexico could service its debt if their new President got up in the morning and said:

> I can't do it. It's failed. I can't do it, so I'm suspending today. I'm going to Washington and I'm going to ask for the United States to enter into a free trade agreement with Mexico. I am suspending the 51 percent foreign ownership and I'm going to contact this morning by telegram all of our major creditors and I'm going to put Pemex on the market first in a debt for equity swap.

If the new President of Mexico did that, within a month they wouldn't need our help. If you can give us a way we could help encourage him to do those things, I'm certainly willing to listen.

So let me stop and let you take the rest of my time.

Mr. **Sachs**. They would need our troops, I am afraid, not our help.

Senator **Gramm**. They may need them anyway.

Mr. **Sachs**. I am afraid of that.

Senator **Gramm**. So am I.

Mr. **Sachs**. I think that if we don't do something soon, they are drifting toward class warfare. The lines, the class lines have never been sharper. A Dupree, which used to be an umbrella to smooth over what is one of the world's worst income distributions doesn't function any more, and Salinas has obviously moved down a path which is—if we don't give him some relief, is going to require a lot of internal repression, which I think we are going to rue when that comes.

Well, let me make a couple of points. First, I agree with you that bad policies play a big role in this story, and I have written now—edited four books, written one and dozens of academic papers stressing that. I have also been involved in what I regard as the most comprehensive reform program in Latin America, and that is Bolivia. It is a little place. It is at 14,000 feet. I was happy that Senator Shelby got there.

Senator **Shelby**. And got out too. [Laughter.]

Mr. **Sachs**. And got out, yes. It's a little bit treacherous runway.

But the point is, you are right, that bad policies have played a role. I would also stress to you, however, that while I often stress the role of bad policies, there have been bad shocks, and you in Texas should appreciate very well what terms of trade declines and high interest rates can do. You know, the banking system in Texas is broke, partly because of those bad shocks, and they have the good fortune of having people like me living in Massachusetts to pay off a lot of this.

Senator **Gramm**. That's what Massachusetts is for. [Laughter.]

Mr. **Sachs**. Right.

Senator **Gramm**. At the same time, it's bad.

Mr. **Sachs**. I realize it plays a very useful role politically right now.

Senator **Shelby**. Maybe not politically, but economically.

NEED TIME FOR REFORMS TO TAKE EFFECT

Mr. **Sachs**. But the problem is that other parts of this region that have suffered exactly the same shocks as put Texas into the tank and bankrupted a lot of the banking system are operative in Latin America, and we've got to get a little bit away from Economics I, I really do believe. Bolivia has opened everything. It's done more radical reform. It doesn't grow quickly. There is a long, long period in which these reforms have to take effect, in which there has to be political stability, in which there has to be a great deal of forbearance and so forth to get this thing working. Now Bolivia has had a 60-percent decline on its tin price, which has been the backbone of the country for almost a century. It has had a 60-percent decline on its natural gas price. It has lived on those things. Now people are living at living standards 50 percent below what they were 5 or 6 or 10 years ago. We know that politics doesn't necessarily give time. There is a great deal of unrest, potentially, and actual unrest in a lot of Latin America right now.

We need time to have reforms take effect. We need to get the confidence for investors to put in money and so forth. You don't just turn around, even if you open up the borders and do all the other things. You don't get booming.

And finally, I would say that I would be a little bit less confident in what we really know about development economics. I think we share most of the same philosophy about what ought to be done, but I would just stress that the most successful developers in this world—Taiwan, Korea, Japan and so forth, they don't follow that list of 11 recommendations. They follow a few of them and really violate a lot of them, and a lot of professional economists are scratching their heads and spending a lifetime trying to figure out why they work, contrary to that list.

Senator GRAMM. Oh, I would say they would work better.

Mr. SACHS. Well, that may be, but I would settle for 13 percent growth anyway. But my point is that if you look at what is happening in the region right now, there are some places that are not undertaking reform, and I am not interested in giving them relief, I want to be clear. What I am interested in doing is sending a message that relief is at hand for those that get serious about their policies, and at the same time, there are governments that are absolutely serious and are drowning right now. They are drowning, and we've got to get support to them and got to send a signal to others, because when you have demagogs running for election right now, saying we are not going to pay any of this, and we are going to do all of that, you have to have the responsible person be able to say, follow me, I am going to get you out of this, and there is help from the other side, and that message is not available, Senator Gramm right now. It is not available for any politician in Latin America. That message cannot honestly be said by a politician. Many pretend to say it.

Mr. Alfonsin, who will do the kinds of reforms you want, if he makes it to power in Argentina, tries to say it, but he's got nothing to say. We haven't helped Alfonsin one moment. When he started down that path of reform in 1985, he was crushed by the financial burden, and then he lost control to the Peronists in the legislature, and that was the end of the process.

So we don't have the message available to our friends in the region that want to do exactly the things that you and I think they ought to do. There is no incentive. More importantly, there is no way for them to win office or to sustain control.

Chile is a long story. One of the things they didn't have to do for 15 years was face an election, and I would just indicate to you that last year, for the first time, Chile had a huge overrun in its monetary targeting. Well, lo and behold, they had the first election that they had to face, and like everyone else in the world, when you have an election, you have difficult problems in keeping economic control. We got to understand the realities of this. We have to understand that those are the realities that led you to give a 6-year timetable to the budget reduction, when it ought to have been done in a year or two and could have been done. There are limits to what is politically possible, and what I am trying to suggest is that if you are looking at it from the Latin American side, or it is hard without being there to understand how tumultuous the environment is right now and how many right-thinking politicians there are that will not be able to carry out a reform agenda, unless we do something different.

Senator **Gramm**. Thank you, Mr. Chairman. [Applause.]

Senator **Sarbanes**. I would just make the observation that, you know, we have not experienced some of these things, and it is very difficult then to fully appreciate—I mean, if we had a drop of 50 percent in the standard of living in this country over a 5-year period, we would have some appreciation for what the repercussions or ramifications are of that for the leaders in the country. We haven't had anything comparable to that. We get trouble when the standard stagnates, let alone a 50-percent reduction. Senator Shelby.

Senator **Shelby**. Thank you. Professor Sachs, you, I believe, state the economic and political arguments well. I did appreciate Professor Hanke's outlining what I asked earlier, how we can link the economic reforms to external debt relief. And I believe you approached it a little differently, but you agree that both aspects of the solution are essential.

Mr. **Hanke**. Oh, absolutely.

Senator **Shelby**. And without internal reforms, external relief is like turning over a credit card to someone who is just going to charge again after you pay his debt off. Is that about right?

Mr. **Hanke**. Absolutely.

Senator **Shelby**. You are absolutely right about the politics of it, and I don't want to overemphasize, I don't think I can overemphasize, the politics will follow the economics just about always. You've got to have structural reforms. I was in Argentina where the lights are not on all the time, when they're glad to have daylight, when they are glad to have a little breeze blowing down there—its now summer. I had the opportunity, as you mentioned, to go to Bolivia. They have made great strides. It is a small country, but I believe it is a country that we cannot ignore, not just because of economics but because of the narcotics, the cocaine. In Peru—Peru is in shambles. And you mentioned Chile. Chile has a big election coming up in December, and we hope and pray that it is going to come out all right, that the people are going to make a wise choice in what they are doing. It will be their first election. The absence of elections has made it a lot easier from an internal perspective to make these economic reforms. They certainly have made progress.

When I was in Argentina, I spoke with the Economics Minister. I asked, when and how they would privatize. I think they are a long way from doing this. There's been a tremendous reluctance for debt-to-equity swaps in that country. I don't know if swaps are a complete solution but it is a technique to consider. We know the roots of the problem. But debt relief has got to be linked to internal reforms. Without internal reforms, there is little chance of going forward.

HAVE BANKS MADE MONEY ON THESE LOANS?

I want to ask all of you this question. There have been articles published that suggest that a lot of our banks really made money on the front end of these loans, a lot more money than a lot of us realize, and that they will not take the big hit overall that we think. Maybe they have taken the money and declared dividends or spent it and so forth, and the bank is still carrying it.

Is there any credence to that?

Professor Hanke, you first.

Mr. HANKE. I am not familiar with the internal profit structure of the banks.

Senator SHELBY. Have you ever examined any of them?

Mr. HANKE. No.

Senator SHELBY. OK. Have you read any of the articles?

Mr. HANKE. I have read some of the articles, but personally, I don't have any firsthand knowledge of that.

Senator SHELBY. Professor Sachs, you've done a lot of work in this area. Have you done any focusing on the internal structure of the banks?

Mr. SACHS. Oh, yes.

Senator SHELBY. What kind of hit would they take.

Mr. SACHS. Quite a bit. I think the most important thing that can be said about the banks is that a lot of our policy in the last few years, as Latin America has gotten deeper and deeper into crisis has looked the other way intentionally to give the banks some time to get out of the problem, and I think that the single most important fact right now about the crisis is that the banks, and I mean all of the banks, everything in this country is out of this crisis right now. They did get the large front-end fees when they started this business. They received very large spreads for a long time. Indeed, in the early reschedulings, the name of the game was when the country got into trouble, raised the spread for a few years. Finally, that's been whittled down, but you know it is interesting with the hundreds of commercial bank restructurings, there hasn't been a single case of a submarket interest rate, not one single case. There's been a positive spread on every single restructuring that has been made. That is for 42 countries, each of which have had two or three rounds at this point.

I wanted to quote Mr. Seidman, who I guess you are seeing a lot of these days.

Senator SHELBY. We see him a lot.

Mr. SACHS. Right. I had the pleasure to testify with him on the House side a couple of weeks ago, and I wanted to just mention his testimony. He said, moreover, even in what could surely be considered a worst case scenario, each if the nine money center banks could write off 100 percent of their outstanding loans to the six largest debtor countries, and on an after-tax basis, each of these banks would remain solvent.

This is a stunning, very helpful bit of testimony. He was taking great pains to say the FDIC is out of trouble with this problem. But what it means for us is that it is time to look at some of the other objectives in this issue rather than simply the objective of keeping bank profits whole.

PROCESS OF SETTING UP INTERNAL REFORMS

Senator **Shelby**. How do you mechanically set up the linkage of internal reforms that we have been talking about?

Mr. **Sachs**. Well, Senator Shelby, we have that mechanism at hand right now. That is the IMF and the World Bank. I am a big supporter of both of those institutions. I think they are highly professional, and they potentially can do a tremendous job. The problem is, we have given them the wrong task right now. We have given them the task to go down there and collect, and so we get ridiculous programs out of them, programs that fall apart in 2 months, 3 months, require waiver after waiver after waiver, but what they really should be doing is doing economic reform. And in Bolivia, where I have been advising the President for almost 4 years now, once we got over the hurdle of the debt and recognized that that was a payable debt, the IMF and the World Bank have been tremendously beneficial in sticking to, in keeping them on a path of reform, in suggesting the right reforms and doing the technical work to get those reforms under way.

Bolivia is probably the only country in the region where the IMF is not the political villain of the left. In fact, the candidate of the left right now, Jaime Pasomora, said in a speech last week that he would abide by the terms of the IMF agreement, and that is because the IMF is doing reasonable policies there. It is helping the reform process. It is not down there collecting bank debt that is unpayable.

And so I think we have the mechanism. We have to lodge the facility in the international institutions and then let them do their real job, which they are darn good at.

Senator **Shelby**. What percentage, if you can make a judgment, of the total outstanding debt do you think will ever be paid back?

PERCENTAGE OF TOTAL DEBT TO BE REPAID

Mr. **Sachs**. I think that it is very important to keep in mind the vast variety of problems and experiences among countries right now. This is more than a crisis of Brazil and Mexico and Argentina. As I mentioned, there are 42 countries engaged in active commercial bank reschedulings. For some of them, you can't look for more than 5 or 10 cents. We ought to get Peru out very cheaply, out for nothing right now, if they turn around, because we are going to have a major foreign policy problem there. They supply the bulk of the coca that comes to the United States in the form of processed cocaine. They have a guerrilla terrorist movement, and they have a hyperinflation. We have got to at least let them know that if they turn that around, and we will help them, that that is basically going to be written off, because it will never be paid by the Sandero Luminosa, I can assure you. It is not going to be paid by the narco trafficontos either. So we have got to recognize that we have got goals there, and that means deep reduction.

For Mexico, I would put the number around half. They can reasonably service, in my view, about half the debt, and probably Brazil around the same amount and Argentina somewhat less.

These are based on a variety of indicators. I don't think that there is a single measure. This depends on the political fragility of the situation, very importantly. It depends on debt ratios; it depends on the nature of export diversification; it depends on levels of private savings and investment, and so forth. But in my view, the secondary market is not a bad indicator, broadly speaking.

Senator **SHELBY**. As to value.

Mr. **SACHS**. As to the value, yes.

Mr. **HANKE**. One thing, Senator, I would like to——

Senator **SHELBY**. I am taking his time, but I think you've got something to say.

Mr. **HANKE**. I would like to differ a little with Professor Sachs. I was down in Buenos Aires last month without the lights also.

Senator **SHELBY**. We must have been on the same elevator. [Laughter.]

Mr. **HANKE**. We probably were, and all the politicians, of course, all these responsible centrist politicians that the professor is talking about were down at the beach, as you know. So that if you actually talk as an investor, and I was there evaluating investment projects, and by the way, we had one that was generating a 70-percent rate of return on an annual basis that we rejected because of country risk. So this is the kind of thing you are facing down there in terms of outside investors putting their capital in.

But I have not met this responsible core of politicians who would move toward the 11 liberalization conditions that I mentioned which, by the way, were developed in part by studies on Taiwan by Professor Al Harburger in his rather massive book on economic growth, in which these conditions were laid out, and I think fairly well documented.

So I think the conditions hold, there is general agreement to it. I think the responsible politicians who could perhaps implement these or who have thought about them are not available to a large degree in Latin America, and this is part of the problem. So that is why you want the linkage to give these people the incentive, you really hold something out that looks attractive to them and maybe they will get interested in looking into some of these liberal reforms and getting the thing on the right track, so that outside investors like Friburg Commodity Management, where I am chief economist, would put more money in Latin America.

We were starting an international mutual fund 3 years ago. It was to be focused on South America, and there was only one country that could pass muster at all, and that was Chile. And so we have set up a mutual fund in Santiago that has done rather well because of the economic growth that is occurring down there.

Senator **SHELBY**. I appreciate the chairman's indulgence on the time.

Senator **SARBANES**. I would like to ask, just for my own factual edification, why the lights are going off in Argentina.

FAILURE OF THE HYDROELECTRIC SYSTEM IN ARGENTINA

Mr. **HANKE**. Well, most of the electricity capacity is hydro, and it has been extremely dry, so that's——

Senator **SARBANES**. Now what economic policy of theirs was it that caused the drought and therefore caused the hydroelectric not to work?

Mr. **Hanke**. That wasn't a problem there. They can't control that. They can't control much of anything, but they certainly don't control the weather.

Senator **Sarbanes**. OK. There are lots of things to beat up on Argentina about in terms of their economic policy but——

Mr. **Hanke**. Well, there is an economic reason though. The electricity is underpriced, for one thing, which created rapid build ups in demand, artificial growth in effect and demand. That is one problem, and the other problem is that the thermal electric capacity has not been maintained and replaced on a regular basis, on a responsible basis.

Senator **Sarbanes**. I think the second point is a good one, but my understanding was that Argentina without oil resources made a major effort to develop hydroelectric sources, which makes a lot of sense in the circumstance, it seems to me, and has obviously a lot of other benefits, environmental amongst them, and that one of the prime reasons for this difficulty now on electricity, although I grant this failure to maintenance point, so some it is attributed to that, and that is something they ought to justifiably be criticized about, but a good part of it is due to the drought, which has made this reliance on hydroelectric not prove out. It is an external cause over which they have no control.

Am I wrong about that?

Mr. **Sachs**. Well, the weather is a factor, but I think that the investment levels have been very low on infrastructure across the board in Argentina. Indeed, the estimates in a project that I supervised at the National Bureau of Economic Research showed that they weren't even keeping the capital stock at a given level, that actually Argentina has been a net disinvestor for the past several years. In other words, the place is crumbling, and I think that the lights are one indication.

I didn't mean that when I mentioned it, by the way, as an attack on the Government. Quite the contrary, I regard the decline in investment as one of the prime symptoms of the debt overhang and the heavy burden of international resource transfer. So this decline in investment rates isn't something that is limited to Argentina. It is something that is across-the-board in the debtor world and, in fact, in those countries that have debt servicing difficulties, you have seen investment rates as a percentage of GNP fall by 8, 9 percent of GNP throughout the group of countries in debt servicing difficulty, and that is showing up in the crumbling infrastructure, and it is, in that sense, in addition to the weather and in addition to some problems they have had in nuclear and so forth, is one of the reasons why they are in this terrible box right now.

Senator **Sarbanes**. Well, I think that is a reasonable point, but I am trying to separate out fact from fiction. And I think it is really somewhat unfair if, in fact, the reason that there is this electricity shortage which leads to all these reports, you know, the elevator doesn't run and the lights are only on a certain amount of the day, and then you say, "Well, now why is this? Why has this happened?" And then someone says, "Well, it's happened because we have had a drought. Our hydroelectric reliance which at the time seemed sensible, seemed to be a rational decision, isn't proving out." That's all. I think it is important to make that point.

Senator **Shelby**. If the chairman will yield just for an observation, but it also shows that they didn't—or someone didn't invest in alternative means of producing electricity.

Senator **Sarbanes**. Well, then the question is, would it have been rational, economically sensible, at the time to put the limited resources that they have into alternative sources in case a drought came along, and they didn't have hydroelectric. Now that involves the question, is this the kind of drought that happens every year, or is this once in a 10-year drought or once in a 100-year drought?

Mr. **Sachs**. You have exhausted my knowledge by far on this specific point, but I will try to provide some information, if I can, but let me say, though, in all seriousness——

Senator **Sarbanes**. If they had a hydroelectric system that was working, based on reasonable premises, and then they spent a lot of money for an alternative system just in case a drought came along, and no drought came along, people would be sitting here criticizing them for that wasteful expenditure.

Mr. **Sachs**. Senator Sarbanes, I think there is a more general point, and unfortunately, I am ignorant of this specific point more than what I have been able to say.

Senator **Sarbanes**. Well, I don't quarrel with you.

Mr. **Sachs**. When the budget got into trouble and when the foreign lending dried up and when the huge net resource transfers outward came in the early 1980's, the first thing to go was government investment everywhere, and that is because once you have squeezed the real wages of public sector workers 30 or 40 percent in many of these countries, you can't do it and maintain sensible, sound, forward-looking investment programs without generating even more pain. It is the same thing that happened in this country. As we have squeezed the budget, we have cut out government infrastructure investment spending. But there it has been even more dramatic, because it has been 6, 7, or 8 percent of GNP in these countries, and we will just have to find out how many hours per day the lights out is really attributable to that.

But the more general problems of decaying infrastructure are evident widely throughout Latin America, and I think that is a——

Senator **Sarbanes**. Well, I just want to make the discussion rational. I don't disagree with the general point. In 1930, Argentina was seventh in the world in per capita income, in 1930. Today they are 59th. If you look at why, it is because, you know, there have been a lot of bad economic policies and government is not up to the task over the last half century in Argentina. So there is plenty of criticism that can be made. But this kind of glib thing, "Well, the Argentine economy isn't working because the lights are going out in Argentina." Why are the lights going out in Argentina? What I am asserting is it is primarily related to a drought, it is—you know, use some other metaphor to demonstrate it.

Senator **Shelby**. Well, I think that is just part of it.

Senator **Sarbanes**. Almost.

Mr. **Hanke**. Senator, if I could just follow up. Professor Sachs has reviewed the supply side of the infrastructure problem, but there is a demand side that is strictly related to economic means and mechanisms for allocating these scarce infrastructure resources, and in Argentina, if we are speaking rationally of the problem, they have had an explosion in the demand for electric power, because they price it at below cost, so that you have to look at both the supply side, which we have been talking about, as well as the demand side, if you really want to do a rational economic analysis.

Senator SARBANES. If there had been no drought in Argentina this year, would the lights have gone out?

Mr. HANKE. They would probably have gone out or browned out part of the time.

Senator SARBANES. All right. I want to ask about Chile, which is being held up as a model. I had a long discussion with Somerville. Do you know Somerville, their debt negotiator?

Mr. HANKE. Yes.

Senator SARBANES. He was complaining bitterly. He says, we have done all these things. We can't get any medium credit from the banks. He says they are still not bringing us back into the normal lending situation.

What is the response to that? What do you say to him?

CHILEAN PROBLEM

Mr. HANKE. Well, perhaps it is a little bit too early. Let me just back up. Part of the problem with Chile is somewhat unique on that end, because the American political scene has been leaning on them so heavily that there is a little bit of a negative tone in the air. So that is part of the problem, but the other thing that I started with is that it is perhaps a little bit too early, and they do anticipate, in fact, he anticipates being back in the market by no later than 1990 for new loans. So his statement—I don't know when you talked to him, of course, he has resigned now.

Senator SARBANES. I talked to him in December. He is out now, but I talked to him in December.

Mr. HANKE. He is out now, but they do anticipate being back in no later than 1990.

Senator SARBANES. Now Chile's bank debt is down; correct?

Mr. HANKE. That's correct.

Senator SARBANES. Is their debt to the international institutions up?

Mr. HANKE. No.

Mr. SACHS. Yes.

Senator SARBANES. It is up by a major factor.

Mr. SACHS. Up by 5 percent of GNP.

Senator SARBANES. If you look at the Chile table, a good part of the reduction in bank debt, private bank debt, had been, in effect, displaced or replaced by an increase in debt to the World Bank and comparable international institutions. Not one for one, but it's a large part of that improvement. What has happened in Chile is, they have, to some degree, transferred the debt from the private sector to the international public sectors. Mr. Schulmann.

Mr. SCHULMANN. I may mention a few numbers, Mr. Chairman, that throw some light on this. Basically, the external debt of Chile has been rather stable in dollar terms throughout the 1980s. It has moved between $18 and $22 billion, and at the end of 1988, it stood at $19 billion. The commercial bank debt peaked in 1985, when it was $15.4, and it is now down to $11.3 billion. So at least a part of the reduction of the commercial bank debt has translated into a reduction of Chile's overall debt.

Senator **Sarbanes**. Yes, part of it. I said it wasn't one for one, but often we are cited the deduction in private bank debt figures without appreciating that to some degree, it has been offset by an increase in public institutional debt. Did you want to add to that?

Mr. **Sachs**. Yes. I may have to correct this for this. My recollection is that approximately—the bank debt has come down by $7 billion and the official debt has gone up by 5. So it has been a 5-to-7 ratio. There has also been an increase in the liabilities of the economy, because starting in 1990—1991, there will be the repatriation of profits on the debt equity, which has not been allowed yet. I think that the reason that they are not back in the market is that they have a tremendous debt overhang. Their debt, their net debt is still about 85 percent of GNP. It does have this different composition, in fact, a much tougher composition to reduce now. And given another 10 to 20 percent of GNP in foreign holdings of corporations or equity in Chile, there is probably about 100 percent of GNP in net claims of foreigners on the Chilean economy.

Now what that means is that if they have to transfer the profits and interest on that, they are going to have to be running on average a trade surplus or a nonfactor current account balance, as we say, of about 10 percent of GNP per year. Well, they have never come close to that. What they have done in recent years is borrow a lot to cover these interest payments. They borrowed a lot from the official community and actually had the highest debt GNP ratio but the lowest actual payments, because they have been doing—lowest net resource transfer, because they have been doing so much borrowing.

So the test hasn't come yet, and that is why they don't have market access. They have a tremendous burden coming up, plus a social overhang, if you will. It is estimated now that 45 percent of the population lives in absolute poverty, and they are about to start the great experiment in democracy. So it doesn't surprise me that the banks aren't jumping in right now with new lending. They haven't come close to getting out of their problem.

Senator **Sarbanes**. Well, gentlemen, we thank you very much. You have been a very helpful panel.

The hearing stands adjourned.

[Whereupon, at 1 p.m., the hearing was adjourned.]

NEW APPROACHES TO THE THIRD WORLD DEBT PROBLEM

THURSDAY, MARCH 16, 1989

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,
Washington, DC.

The subcommittee met at 9 a.m., in room SD-226 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (chairman of the subcommittee) presiding.

Present: Senators Sarbanes, Dixon, Shelby, Graham, Kerry, Heinz, Gramm, and Riegle.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. The Subcommittee on International Finance meets today to review the proposals put forward last week by Secretary of the Treasury Brady on the Third World debt problem, which is seriously impacting developing and developed countries alike.

In important respects, those proposals, which for the first time recognize the concept of the necessity of some reduction in debt and debt service, hold out the prospect of a significant new approach to the problem.

To paraphrase Winston Churchill, this is not so much the beginning of the end or even the end of the beginning, but it does at least look to be the beginning of the beginning, and we are very anxious to work with the Treasury in this as we try to move forward.

Secretary Brady noted in his speech on Friday, and I quote:

> Commercial banks need to work with debtor nations to provide a broader range of alternatives for financial support, including greater efforts to achieve both debt and debt service reduction and to provide new lending.

The call for a broader range of alternatives extending to both debt and debt service reduction represents a major departure from past policies. Existing approaches have created a legacy of years of austerity, a decline in living standards, and a growing challenge to democratic institutions.

Unfortunately, the Baker plan, the premise of which I accept, which was to produce economic growth and a flow of capital, but unfortunately it did not.

It has been apparent for some time that the heavily indebted countries cannot sustain the large-scale export of scarce savings which their debt service obligations and the lack of adequate new lending have produced.

The Inter-American Dialogue in its recent report, on which we held a hearing earlier this year, said, and I quote:

> Creditor countries and banks increasingly recognize that the economies of Latin America cannot be restructured and primed for growth without substantially higher levels of external capital. The region's capital requirements cannot be met by new lending alone, and a debt reduction is therefore essential.

Well, the debt issue involves more than the heavily indebted nations in the developing world and the creditor banks in the industrial world. Its ramifications extend to the functioning of the world trading system and to the diplomatic and political relations between developed and developing nations, including, in particular, our own relations in Latin America.

Also, frequently at stake is the legitimacy of democratic governments in the debtor countries, where austerity policies of the past encourage demagogs of both the right and the left. Recent events in Venezuela were a sober illustration of this point.

As the Financial Times observed in a recent editorial, and I quote:

> Increasingly, it is becoming a question of how Latin American governments can retain fragile democracies when their economies are condemned to stagnation through a vicious cycle of austerity and an insufficient flow of external resources.

At this important juncture in debt policy, the question is how best to proceed. A number of recent public reports on which hearings were held by this subcommittee revealed the emergence of a broad consensus among a number of distinguished groups on the principles of an effective debt strategy.

First, the strategy should be long term to remove the element of uncertainty, which is so debilitating to growth; comprehensive, to involve all debtor countries, not merely the large or strategically significant; and flexible enough to treat different countries differently.

A comprehensive approach does not mean an across the board solution which fails to recognize differences in policy or circumstances.

Second, the provision of new resources, whether through new lending or debt relief or a combination of both, must be linked to continued momentum on policy reform in the debtor countries, the real goal of any effective debt strategies to restart the growth process, which requires both external resources and appropriate internal policies.

Third, the debt problem is an international one. American banks hold only a third of the loans to troubled debtors. The problem must be met with multilateral and not unilateral solutions. Multilateral solutions also hold out the possibility of addressing the larger problem of major trade imbalances, which threaten to undermine world recovery.

To the maximum extent possible, debt reduction for developing countries should be facilitated through the recycling of capital from countries with large current account surpluses like Japan and West Germany. Such an approach to the Third World debt problem could provide an opportunity for more equitable and realistic economic burden sharing, which is long overdue.

It is against this background of experience that we will hear the testimony of Treasury Under Secretary Designate for International Affairs David Mulford on the Treasury initiative.

In his Friday speech, Secretary Brady called for an expanded role for the World Bank and the IMF as well as greater flexibility for commercial banks to negotiate individual debt agreements with debtor countries.

This morning the subcommittee will seek to have these proposals addressed in greater detail and to determine the Treasury's view on the scale of the proposal that has now been put forward.

Now, I will turn to Under Secretary Designate Mulford. David, before we hear from you I will turn to my colleagues if they have any opening statements.

Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Thank you, Mr. Chairman.

Mr. Chairman, let me first say that since 1982 we have seen a dramatic change in the debt picture, and I view it as being a change for the worse in one key respect.

In 1982, 64 percent of the Third World debt was held by banks. That has declined to 56 percent. We might view that as progress. The problem is that the international financial institutions have seen their total share of the holding of this debt rise from 7 percent to 16 percent, more than double.

That is nothing more than collectivizing the Third World debt and, since we are now facing a debate concerning bailing out the depositors of savings and loans, one bailout in this decade is enough.

I am determined to see that the taxpayer does not end up holding the bag for Third World debt.

Also, Mr. Chairman, while there was much in the statement by Secretary Brady that I applaud, there was one sentence that I at least want to take some exception to. This was the statement on Friday, March 10. The Secretary of the Treasury said:

> With respect to the Fund, the implementation of these new efforts to strengthen the debt strategy could lay the basis for an increase in IMF quotas.

I want to say, Mr. Chairman, that I intend to oppose any effort to raise IMF quotas and, in the process, put the taxpayer of this country in line to pick up the tab on Third World debt.

Finally, Mr. Chairman, let me say that the problem in terms of Third World debt is one of lack of viable economic systems. No amount of debt reduction is going to solve the problem because it doesn't change the causes. The problem is that much of the Third World has incurred debt to use the money for spending. No capital or wealth creation has occurred. Now, the debt has come due. To simply forgive the debt is to put off a day of reckoning in terms of economic reform, and I am not in favor of that.

There are very few troubled debtor nations in this world that could not substantially change their debt situation by simply having their own citizens bring their own capital back to their own country. Their citizens don't do that because they have less confidence in their own country than they would like to ask us to have.

I think this is a serious problem. I am concerned about it. I want to work on it. I applaud you, Mr. Chairman, for holding this hearing and for making proposals to deal with the problem, but I believe the solution to the problem is through economic growth and reform. I know that it is very difficult to make hard decisions. I think it is clear that in the Third World it is especially difficult where democracy is fragile.

But I don't think we help ourselves by creating false expectations that somehow we are going to rush in and solve this problem and debtor countries are not going to have to make difficult decisions. I think they are going to have to make those decisions.

In summary, I believe the Third World debt problem can be dealt with. Most of the effort has to come from the debtors. If they are willing to do what has to be done, I think we ought to help them. If they are not willing to do it, I don't think we ought to incur more debt or extend them more credit, thereby making their problem and ours greater.

Thank you, Mr. Chairman.

Senator SARBANES. Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, I first would like to thank you for scheduling this hearing.

Secretary Brady made an important speech last Friday, outlining his new approach to Third World debt. I have many questions about Secretary Brady's proposal, and I am pleased, Mr. Chairman, that you scheduled this morning's hearing in such short order.

I look forward to hearing the testimony of the Assistant Secretary for International Affairs and Under Secretary Designate David Mulford.

I congratulate Secretary Brady for taking a hard look at reality and acknowledging that we must shift our focus from the Baker plan to debt and debt service reduction.

When the debt crisis broke onto the international scene in the early 1980's, debtor countries, banks, and creditor countries started scrambling. We were frankly afraid of widespread defaults that could have been large enough to cause an international financial crisis. We muddled through by rescheduling and restructuring debt payments.

But that stage is now over. In fact, it has been over for several years. We must now move beyond the stage of muddling through, of having banks increase lending only enough for debtor countries to keep up with ever more burdensome interest payments.

We must stop increasing the cash outflow of debtor countries and start reducing it. We must restore growth in their economies and not just wish it to be so.

Debt service and debt principal reduction is a proper approach, but the central focus must be on cutting down the size of the cash outflow from debtor countries. Every dollar of principal that is written down does not necessarily make a significant dent in the burdensome payments debtor countries are making.

In addition, I am skeptical whether we can entice banks into lending new money at the same time that they are writing down the principal of old loans unless the enticements are more dramatic and creative than those outlined to date.

No longer is the international debt problem an issue of bank security. It is not a vital and ominous foreign relations, national security, and trade issue.

Brazil is suffering from 1000 percent inflation. Our next-door neighbor, Mexico, has a frightening unemployment rate. In Venezuela people are rioting in the streets.

Bank security may not be at stake, but democracy is, and, self-interestedly, vast markets for U.S. exports are at stake as well.

So I welcome the policy change that Secretary Brady has signaled, but we need more, Mr. Chairman, more details, more careful thinking and bolder international initiatives.

Senator **Sarbanes**. Thank you very much.

Senator Heinz.

Senator **Heinz**. Mr. Chairman, I have a statement, but I would like to put it in the record, if I may.

Senator **Sarbanes**. The statement will be included in the record.

Senator **Heinz**. I would simply like to commend you, Mr. Chairman, on having this hearing. I think that the new policy of the administration is welcome, but I would like to associate myself with those that withhold judgment on it until we hear all the details, particularly from Mr. Mulford and others, on the plan.

A critical issue is not just whether it will be possible for any brokers of debt reduction, which presumably will be the IMF and the World Bank, but will be able to also broker the necessary internal economic reforms. There remains of course the willingness of the countries themselves to participate in this kind of debt swap, which envisages, of course, above all countries purchasing their debt or, as was attempted with Mexico, some other creative financial arrangement to defease it and otherwise reduce it, and it is not exactly clear yet to many of us how interested every debtor is going to be in making this work.

Nonetheless, as long as the program is indeed voluntary for both the debtors as well as the lenders, there is some prospect of this reducing debt load, reducing interest payments, and facilitating the return of capital to these countries.

So I am most interested in the substance of this hearing and hope that Secretary Mulford will be prepared to answer all those questions.

Senator **Sarbanes**. Senator Shelby.

Senator **Shelby**. Mr. Chairman, I have a statement. I would like all of it to be included in the record.

Senator **Sarbanes**. It is included in the record.

STATEMENT BY SENATOR SHELBY

Senator **Shelby**. Mr. Chairman, I commend you for calling this hearing this morning so that we might have the opportunity to hear more about the Tresaury's proposal to address the Third World debt problem.

I have also read the report on accounting and regulatory policy which was recently prepared by the banking regulators and found it very helpful. It provides a clear, succinct description of the treatment of Third World debt on the books of banks.

I interpret the report's findings to mean that there is adequate flexibility in both regulatory and accounting policy for banks to take advantage of innovative debt reduction strategies. This is both good and bad news; it is good because it means banks can devise favorable schemes to reduce their debt within the present regulatory framework. It is bad because relatively little has yet been done to ameliorate the LDC debt situation and this report suggests that it is not the lack of regulatory and accounting flexibility that is responsible.

Recent incidents in Venezuela serve as a tragic reminder of the necessity of coming to grips with the Third World debt issue. Violent uprisings prove that the debt problem threatens not only economic but also social, and political stability in our Third World neighbors. Countries that are willing to suffer the social and economic costs of painful austerity programs should be rewarded with relief from the creditor nations. Not only does relief provide encouragement for the debtor nation to continue its austerity program, but it also provides an incentive for other debtor nations to adopt similar policies of economic reform.

From what I have read, the Treasury's new initiative incorporates this essential stick and carrot strategy. I commend the Treasury for offering a proposal that accepts the necessity of debt relief. I am not familiar with the details of the proposal and I look forward to what our witness has to say.

Having said that, recent incidents in Venezuela serve as a tragic reminder to all of us of the necessity of coming to grips with the Third World debt issue. It is not just going to go away. Violent uprisings prove that the debt problem threatens not only economic, but also social and political stability in our Third World neighbors.

Countries that are willing to suffer the social and economic cost of painful austerity programs I believe should be rewarded with relief from the creditor nations and banks. Not only does relief provide encouragement for the debtor nation to continue its austerity program, but it also provides, Mr. Chairman, an incentive for other debtor nations to adopt similar policies of economic reform.

From what I have read, the Treasury's new initiative incorporates this essential stick and carrot strategy. I commend the Treasury for offering the proposal that accepts the necessity of debt relief, and I look forward to hearing more of the details. Thank you, Mr. Chairman.

Senator **Sarbanes**. Secretary Mulford, I think we are ready to hear from you. We welcome you here this morning.

STATEMENT OF DAVID C. MULFORD, UNDER SECRETARY DESIGNATE FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. **Mulford**. Thank you, Mr. Chairman.

May I make a suggestion as to how I might proceed if it is acceptable to you because I know members of the committee want to spend time questioning me?

So rather than read my entire statement, I would suggest that I touch on the section that summarizes the report, which was submitted last night, on the question of the International Debt Management Authority.

There are two other reports that were submitted to the Congress which are in my testimony, but I will not touch on unless members wish to raise questions, and then I will move straight into a brief description of the new proposals and open it to questions.

Senator SARBANES. Fine, and the entire statement will of course be included in the record.

Mr. MULFORD. Thank you.

Well, turning to the first report on the negotiation of an International Debt Management Authority, the Treasury Department has reviewed many international debt facility proposals. Most of these proposals have several common elements, including a significant up-front injection of capital and the assumption of full risk on principal and interest.

As required by the legislation, the report assesses the use of IMF gold stock and World Bank uncommitted liquid assets to establish such an Authority. With regard to the use of IMF gold stock, the report notes that mobilization of gold for the Authority could only be accomplished through the sale of gold, with proceeds made available to the Authority. Such sales would reduce the IMF's basic reserves, which serve as backing for creditor claims on the IMF. They could have an adverse impact on gold prices and international gold reserves of the U.S. and other countries. Since only a small segment of IMF membership would benefit directly from this use of gold stocks, it would be extremely difficult to obtain the 85 percent majority vote necessary to authorize IMF gold sales for the Authority.

The use of the World Bank resources to establish such an authority would also be constrained by financial and legal obstacles. The Bank's liquid assets are earmarked to fund contractual lending commitments. These assets afford the Bank a margin of flexibility in raising funds in the international capital markets. Pledging Bank assets to do a debt authority could affect the Bank's creditworthiness and increase its cost of funding.

On the legal side, the Bank's articles of agreement do not cover the pledging of liquid assets. Moreover, pledging of the Bank's assets could raise questions concerning negative pledge clauses in the agreements under which the Bank is a borrower. Each such clause typically provides that the Bank cannot pledge its assets to secure its obligations unless the benefits of the pledge are shared equally by the lenders which are parties to the agreement.

Our assessment concluded that negotiation of an authority could materially increase the likelihood of payment interruptions and a further decline in secondary market prices. We believe that the suggested market-oriented approach outlined by Secretary Brady on March 10 addresses congressional concerns in substance with less risk to taxpayers.

Voluntary debt reduction techniques have been developed by the commercial banks and by debtor countries in response to both the banks' strategies and goals, and debtor nations' appetite for capturing the discount on their debt. All of the 15 heavily indebted middle income countries, with the exception of Colombia, Ivory Coast and Morocco, have participated in voluntary, market-driven debt reduction operations totaling $28 billion since 1985.

We have concluded after months of study that debt reduction and debt service reduction can be successfully accomplished in the marketplace.

We have reviewed numerous debt facility proposals in preparing the report at hand, and I would stress not with jaundiced eyes but with a fresh view. In the final analysis, however, we have reaffirmed a market-oriented approach that would encompass both voluntary reduction in debt and access to private capital, while minimizing the expense and risk to the public sector.

Turning to the strengthening of the debt strategy, Mr. Chairman, let me make a few brief remarks before opening to questions.

The debt difficulties of developing countries remain a serious global problem which requires cooperative efforts on the part of all parties. Following a thorough review of the current approach by the administration, Secretary Brady has recently outlined suggestions for strengthening the international debt strategy. Our suggested approach builds on the basic principles that have guided international efforts in recent years. It recognizes that continued vital importance of stronger growth, debtor reforms, external financial support, and a case-by-case approach to individual nations' problems.

Our suggestions would maintain a central role for the IMF and the World Bank within the debt strategy in encouraging debtor policy reforms and catalyzing financial support, and recognize the continuing need for new lending from commercial banks. However, we would also place strong emphasis on new investment flows and the repatriation of flight capital as alternative sources of private capital. To this end, we would encourage the IMF and World Bank to work with debtor nations to focus on specific measures to improve the investment climate and encourage the return of flight capital as part of their policy-based loan programs, in addition to vital macroeconomic and structural reforms.

In addition, we would focus international efforts on achieving more rapid and broadly based voluntary debt reduction during the next 3 years in order to ease debt burdens and improve prospects for stronger growth. One of the key factors at play in determining the extent of voluntary debt reduction activity is the legal constraints within existing commercial bank agreements, which must be waived by most or all commercial bank participants for each individual debt reduction transaction. Debt/equity swaps and sales in the secondary market are exceptions, but there is a strong interest within debtor nations in obtaining more direct benefits from commercial banks' willingness to reduce their own exposure, as can be obtained through debt/bond exchanges or cash buybacks.

A waiver of such provisions as sharing and negative pledge clauses in existing commercial bank loan agreements could go far to free up market activity in this area, and to accelerate the pace of debt and debt service reduction with direct benefits to debtor nations. Such waivers might have a limited life of perhaps 3 years, to stimulate activity within a short but measurable time- frame.

In addition, an integral part of the approach would be for debtor nations engaged in debt reduction to maintain viable debt/equity swap programs, which have helped to substantially reduce the stock of debt in several countries. Provisions which permit domestic nationals to engage in such transactions can also contribute to the repatriation of flight capital, as we have seen in the case of Chile.

As debtor nations negotiate policy-based loan programs with the IMF and the World Bank, a portion of these loans would be set aside to finance debt reduction transactions negotiated between the debtor and the banks. Such "set-aside" amounts would be used to collateralize discounted debt/bond exchange transactions or to replenish debtor reserves following cash buybacks.

For debtor nations which have negotiated agreements to reduce the stock of debt, the IMF and World Bank would also make available support for interest payments on a rolling basis for a limited period. Such support could be available for transactions which involve either a substantial discount of principal or a major reduction in interest rates.

While the IMF and World Bank would set guidelines on how their funds are used, the negotiation of transactions would remain in the marketplace—encouraged and supported but not managed by the international institutions.

Such transactions could lead to considerable improvements in the cash flow positions of the debtor countries, reducing their needs for external financial support to more manageable levels. Nevertheless, new lending would still be needed—in addition to efforts to repatriate flight capital and attract new investment. Such new financing could include a range of special purpose loans, such as trade credits and project loans, as well as club loans by a group of banks or continued concerted lending in individual cases.

As part of this approach, the creditor governments should also continue to reschedule or restructure their own exposure through the Paris Club, and to maintain export credit cover for countries with sound reform programs. In addition, creditor countries which are in a position to provide additional financing in support of this effort may wish to consider doing so. This could contribute significantly to the overall success of this effort. We believe that creditor governments should also review their regulatory, accounting, and tax regimes with a view to removing impediments to debt reduction, where these exist.

As the chairman has emphasized this morning, broad international support is critical to strengthening the current strategy. It will require cooperative efforts by creditor and debtor governments, the commercial banking community, and the international financial institutions. We have closely consulted with these groups and have sought suggestions from Members of Congress prior to developing the ideas introduced last week by Secretary Brady. The Japanese have expressed their strong support, including a willingness to provide supportive financing, and a number of other creditor and debtor nations have made favorable responses to the general approach we have outlined.

Taken together, the ideas I have discussed today represent a basis on which we can work together to revitalize the current debt strategy. We must address key problems—the restoration of private financial flows, the return of flight capital, the need for sustained economic reforms in many countries, and preservation of financial soundness of the multilateral institutions—if we are to renew progress in addressing international debt problems.

We believe that through the suggestions we have outlined, including efforts to stimulate broader voluntary debt and debt service reduction, substantial benefits can be provided for debtor nations in the form of more manageable debt service obligations, smaller and more realistic financing needs, stronger economic growth, and higher standards of living for their people.

I look forward to consultation with Members of Congress in the weeks and months ahead, and ask you for your support as we develop within the international community a more specific agenda for further action.

I thank you, Mr. Chairman.

[The complete prepared statement, first report, and interim report to the Congress follow:]

For Release Upon Delivery
Expected at 9:00 A.M.
Thursday, March 16, 1989

Statement by the Honorable David C. Mulford
Assistant Secretary of the U.S. Treasury
for International Affairs
before the
Subcommittee on International Finance and Monetary Policy
United States Senate

Mr. Chairman and members of the Subcommittee:

I welcome this opportunity to discuss the two reports that have been transmitted to your full Committee, the Administration's review of the international debt strategy, and our suggestions for strengthening international efforts to alleviate the debt burden in developing countries.

In mid-December, then President-elect Bush called for a thorough reassessment of current public policy on this issue. At that time, the Treasury Department was in the midst of preparing reports, as required by law, that have had a direct bearing on the policy recommendations that we have developed. Therefore, I will open my remarks with a summary and conclusions of the reports.

International Discussions on an International Debt Management Authority

Turning to the report on the negotiation of an International Debt Management Authority, the Treasury Department has reviewed many international debt facility proposals. Most of these proposals have several common elements, including a significant, up-front injection of capital and the assumption of full risk on principal and interest.

As required by the legislation, the report assesses the use of IMF gold stock and World Bank uncommitted liquid assets to establish an Authority. With regard to use of IMF gold stock, the report notes that mobilization of gold for the Authority could only be accomplished through the sale of gold, with proceeds made available to the authority. Such sales would reduce the IMF's basic reserves, which serve as backing for creditor claims on the IMF. They could have an adverse impact on gold prices and international gold reserves of the U.S. and other countries. Since only a small segment of IMF membership would benefit directly from this use of gold stocks, it would be extremely difficult to obtain the 85 percent majority vote necessary to authorize IMF gold sales for the authority.

The use of World Bank resources to establish such an authority would also be constrained by financial and legal obstacles. The Bank's liquid assets are earmarked to fund contractual lending commitments. These assets afford the Bank a margin of flexibility in raising funds in the international capital markets. Pledging Bank assets to a debt authority could affect the Bank's creditworthiness and increase its cost of funding. On the legal side, the Bank's Articles of Agreement do not cover the pledging of liquid assets. Moreover, pledging of the Bank's assets could raise questions concerning negative pledge clauses in agreements under which the Bank is the borrower. Each such clause typically provides that the Bank cannot pledge its assets to secure its obligations unless the benefits of the pledge are shared equally by the lenders which are parties to the agreement.

Our assessment concluded that negotiation of an Authority could materially increase the likelihood of payment interruptions and a further decline in secondary market prices. We believe that the suggested, market-oriented approach outlined by Secretary Brady on March 10 addresses Congressional concerns with less risk to taxpayers.

Voluntary debt reduction techniques have been developed by the commercial banks and debtor countries in response to both the banks' strategies and goals, and debtor nations' appetite for capturing the discount on their debt. All of the 15 heavily indebted middle income countries, with the exception of Colombia, Ivory Coast and Morocco, have participated in voluntary, market-driven debt reduction operations totaling $28 billion since 1985.

We have concluded after months of study that debt reduction and debt service reduction can be successfully accomplished in the market place.

We have reviewed numerous debt facility proposals in preparing the report at hand and, I would stress, not with jaundiced eyes but with a fresh view. In the final analysis, however, we have reaffirmed a market-oriented approach that would encompass both voluntary reduction in debt and access to private capital, while minimizing the expense and risk to the public sector.

The Report on Special Purpose Allocation of SDRs

Pursuant to the 1988 Trade Act, we have studied the feasibility of a special purpose allocation by the IMF of Special Drawing Rights (SDRs) to the poorest countries for use in repaying their debt to foreign governments and international financial institutions. The report concludes that the use of SDRs would undermine adjustment incentives, contribute to inflationary pressures, weaken the liquidity of the SDR and its usefulness as a monetary asset, and undermine the ability of the United States to mobilize its SDR holdings.

The report determined that the IMF's Enhanced Structural Adjustment Facility (ESAF) is a preferred alternative for helping the poorest countries. It suggests that the Administration's request for a $150 million contribution to the ESAF represents a more effective means of providing U.S. support for efforts to deal with the balance of payments and debt problems of the poorest countries.

The Report on the World Bank's Strategy in Debtor Countries

I would like to take a moment to review the conclusions of the report transmitted yesterday to your colleagues in the House of Representatives. As required by H.R. 4645, we have carefully reviewed the World Bank's role in debtor countries. In our judgment, one of the World Bank's most vital functions in these countries is to promote sound economic reform programs through its adjustment programs and to catalyze additional financial support.

In short, after careful study, we have come to conclusions somewhat parallel to the intent of legislators as expressed in H.R. 4645. Additional financial resources and an easing of debt service burdens can strengthen and sustain debtor nations' commitment to economic adjustment programs. The report summarizes our ideas on possible initiatives for voluntary, market-based debt reduction through use of Bank resources. I would underscore, at this juncture, that such funds would be available only for those countries undertaking adjustment programs, and individual transactions would be negotiated between debtors and commercial creditors.

Strengthening the Debt Strategy

The debt difficulties of developing countries remain a serious global problem which requires cooperative efforts on the part of all parties. Following a thorough review of the current approach by the Administration, Secretary Brady has recently outlined suggestions for strengthening the international debt strategy. Our suggested approach builds upon the basic principles that have guided international efforts in recent years. It recognizes the continued vital importance of stronger growth, debtor reforms, external financial support, and a case-by-case approach to individual nations' problems.

Our suggestions would maintain a central role for the IMF and World Bank within the debt strategy in encouraging debtor policy reforms and catalyzing financial support, and recognize the continuing need for new lending from commercial banks. However, we would also place stronger emphasis on new investment flows and the repatriation of flight capital as alternative sources of private capital. To this end, we would encourage the IMF and World Bank to work with debtor nations to focus on specific measures to improve the investment climate and encourage the return of flight capital as part of their policy-based loan programs, in addition to vital macroeconomic and structural reforms.

In addition, we would focus international efforts on achieving more rapid and broadly based, voluntary debt reduction during the next three years in order to ease debt burdens and improve prospects for stronger growth. One of the key factors at play in determining the extent of voluntary debt reduction activity is the legal constraints within existing commercial bank agreements, which must be waived by most or all commercial bank participants for each individual debt reduction transaction. Debt/equity swaps and sales in the secondary market are exceptions, but there is a strong interest within debtor nations in obtaining more direct benefits from commercial banks' willingness to reduce their own exposure -- as can be obtained through debt/bond exchanges or cash buybacks.

A waiver of such provisions as sharing and negative pledge clauses in existing commercial bank loan agreements could go far to free up market activity in this area, and to accelerate the pace of debt and debt service reduction with direct benefits to debtor nations. Such waivers might have a limited life of perhaps three years, to stimulate activity within a short but measurable time frame.

In addition, an integral part of the approach would be for debtor nations engaged in debt reduction to maintain viable debt/equity swap programs, which have helped to substantially reduce the stock of debt in several countries. Provisions which permit domestic nationals to engage in such transactions can also contribute to the repatriation of flight capital, as we have seen in the case of Chile.

As debtor nations negotiate policy-based loan programs with the IMF and the World Bank, a portion of these loans would be set aside to finance debt reduction transactions negotiated between the debtor and the banks. Such "set-aside" amounts would be used to collateralize discounted debt/bond exchange transactions or to replenish debtor reserves following cash buybacks.

For debtor nations which have negotiated agreements to reduce the stock of debt, the IMF and World Bank could also make available support for interest payments on a rolling basis for a limited period. Such support could be available for transactions which involve either a substantial discount of principal or a major reduction in interest rates.

While the IMF and World Bank would set guidelines on how their funds are used, the negotiation of transactions would remain in the market place -- encouraged and supported but not managed by the international institutions.

Such transactions could lead to considerable improvements in the cash flow positions of the debtor countries, reducing their need for external financial support to more manageable levels. Nevertheless, new lending would still be needed -- in addition to efforts to repatriate flight capital and attract new investment. Such new financing could include a range of special purpose loans such as trade credits and project loans, as well as club loans by a group of banks or continued concerted lending in individual cases.

As part of this approach, creditor governments should also continue to reschedule or restructure their own exposure through the Paris Club, and to maintain export credit cover for countries with sound reform programs. In addition, creditor countries which are in a position to provide additional financing in support of this effort may wish to consider doing so. This could contribute significantly to the overall success of this effort. We believe that creditor governments should also review their regulatory, accounting, and tax regimes with a view to removing impediments to debt reduction, where these exist.

Broad international support is critical to strengthening the current strategy. It will require cooperative efforts by creditor and debtor governments, the commercial banking community, and the international financial institutions. We have consulted closely with these groups and have sought suggestions from Members of Congress prior to developing the ideas introduced last week by Secretary Brady. The Japanese have expressed their strong support, including a willingness to provide supportive financing, and a number of other creditor and debtor nations have made favorable responses to the general approach we have outlined.

Conclusion

Taken together, the ideas I have discussed today represent a basis on which we can work together to revitalize the current debt strategy. We must address key problems -- the restoration of private financial flows, the return flight capital, the need for sustained economic reforms in many countries, and preservation of the financial soundness of the multilateral institutions -- if we are to renew progress in addressing international debt problems.

We believe that through the suggestions we have outlined, including efforts to stimulate broader voluntary debt and debt service reduction, substantial benefits can be provided for debtor nations in the form of more manageable debt service obligations, smaller and more realistic financing needs, stronger economic growth, and higher standards of living for their people.

I look forward to consultations with members of Congress in the weeks and months ahead, and ask you for your support as we develop within the international community a more specific agenda for further action. Thank you.

DEPARTMENT OF THE TREASURY

First Report to the Congress
Concerning
World Bank Strategy and Lending Programs
in Debtor Countries

March 1989

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First Report to the Congress Concerning World Bank Strategy in Debtor Countries

SECTION ONE: Legislative Requirements

This report responds to the legislative requirement in H.R. 4645, Section 3(d)[1] that the Secretary of the Treasury prepare a report addressing World Bank strategy and lending programs in debtor countries. The legislation reflects Congressional interest in developing a stronger role for the World Bank in supporting debt reduction -- particularly through the use of policy-based lending to facilitate debt service reduction and through World Bank partial guarantees on debt service payments in financing packages involving significant debt reduction.

Section II of this report examines the current role of the World Bank in the international debt strategy. It describes the World Bank's strategy and lending programs in the "Highly Indebted Countries"[2], as well as in the seriously indebted countries of Sub-Saharan Africa. It spells out the Bank's focus on promoting structural reforms in developing countries to facilitate long-term growth and to ease the burden of debt on these economies.

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[1] As enacted into law by Section 555 of the Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1989 (P.L. 100-461).

[2] The World Bank identifies the following as "Highly Indebted Countries:" Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cote d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

Section III surveys progress made by debtor countries and recent developments in the market vis-a-vis debt reduction. The experiences of debtor countries in implementing adjustment programs and pursuing long-term growth are examined in aggregate and as individual country examples. Further, the report discusses countries' efforts to reduce their debt through market mechanisms and highlights the World Bank's role in facilitating these and other negotiations between debtors and their commercial bank creditors.

The final section of the report summarizes U.S. suggestions for strengthening the current strategy. The new ideas discussed include a greater role for the World Bank in facilitating debt reduction.

SECTION II: The World Bank's Role under the Current Strategy

The debt problems encountered by developing countries in the 1980s have to some extent disrupted the World Bank's efforts to promote development and alleviate poverty in these countries. The international strategy for addressing debt problems has assigned the World Bank an important role in assisting developing countries to undertake programs that will facilitate growth and ease the burden of their debt. The Bank cooperates extensively with the International Monetary Fund to advise countries on policies aimed at both macroeconomic stability and structural reform. Both these institutions are crucial actors in the debt workout process. However, this report will focus exclusively on the World Bank's role.

The Bank's Strategy in the Highly Indebted Countries

The strengthened debt strategy set out in 1985 focused on the need for debtor countries to achieve stronger, sustained growth through comprehensive macroeconomic and structural reforms. The World Bank's long-term strategy for helping the Highly Indebted Countries manage and reduce their debt burden is based on such growth-led recovery.

The Bank's lending programs in each of these countries are designed to facilitate -- through a variety of economic forces -- renewed growth that will gradually reduce debt ratios and lead over time to restored access to financing from private markets. The success of such efforts by the Bank rests in large measure on individual debtor countries' own ability and willingness to implement adjustment programs, as well as the availability of additional financial resources or other financial support for adjustment.

The Bank promotes economic reforms in debtor countries through advice in both the design and execution of adjustment programs. Adjustment lending was introduced in 1980 to help developing countries restore their trade and balance of payments deficits to sustainable levels. Since 1982 and particularly

since 1985, adjustment lending has taken on greater importance due to ongoing economic and financial difficulties in many of the borrowing countries. Accordingly, the scope of adjustment lending has been expanded to provide more comprehensive support for reforms which help countries overcome structural weaknesses and regain sustained growth.

The objectives of adjustment programs are multiple and vary for each country, which is primarily responsible for the design and implementation of its own program. Bank adjustment lending complements investment lending by promoting the appropriate macroeconomic and sectoral policies vital to the success of individual projects. Adjustment programs have been particularly oriented toward:

- market-opening measures to encourage foreign direct investment and capital inflows;
- liberalization of trade, including the reduction of export subsidies;
- reform of tax systems and labor markets;
- development of financial markets to mobilize domestic savings and facilitate efficient investment; and
- increased reliance on the private sector to help increase employment and efficiency.

The Bank's tools for promoting structural adjustment include both Structural Adjustment Loans (SALs) and Sectoral Adjustment Loans (SECALs), which vary mainly in the breadth of the policy and institutional reforms they involve. SALs generally support economy-wide programs to increase domestic resource mobilization and to improve efficiency through reform of trade policies, pricing regulations, government revenue collection and government expenditures. SECALs focus on reforms in specific sectors such as finance, trade, agriculture, industry and energy and target mechanisms including sectoral pricing and the elimination of subsidies for a particular sectoral product or input, for example. The Bank has recently increased its emphasis on SECALs over SALs because their implementation seems to be more manageable for governments.

The Bank has recently evaluated adjustment lending as a mechanism for economic reform and growth inducement. While some shortcomings of methods and implementation were identified, the general conclusion has been that realistic programs are useful instruments for assisting governments in the reform and restructuring of their economies that can help them achieve sustained growth.

The other primary component of Bank strategy in its efforts to promote sustained growth and recovery in developing nations is mobilization of financial resources. Bank programs attempt to tap available resources within an economy that can spur growth; they also facilitate financing from other sources.

Investment financing is the most direct mechanism available to the Bank to stimulate expansion of an economy, and project loans still make up approximately 75% of total Bank lending.

The need for capital, foreign exchange, and technical expertise are essential elements of any program aimed at sustainable economic growth. Direct project financing in the production, social, and infrastructure sectors is a proven mechanism for supplying those elements. Moreover, this type of capital transfer permits the Bank to pinpoint the bulk of its assistance in those sectors it sees as impeding economic growth. Project loans can rehabilitate or restructure existing enterprises; they also work to expand productive capacity. These loans have financed country projects in transportation, education, industry, agricultural and rural development, energy, health and nutrition, water supply and sewerage, urban development, and telecommunications.

The World Bank's role in the reform of individual economies has also enabled it to catalyze additional financial support for adjustment programs. As discussed above, the success of the Bank's efforts in helping a country undertake growth-oriented reforms depends not only on that country's willingness and ability but also on financial support from other sources. The World Bank has taken a more active role in helping countries secure financing in recent years as a means of assuring that adequate resources were available to support reform programs.

The Bank's role in assisting debtor countries to adopt effective reform programs has been the most effective means to mobilize external financial resources required for growth.

Official creditors and commercial banks see the World Bank (and IMF) as credible institutions whose involvement with countries' economic programs serves as certification of these countries' determination to implement effective policies. Such validation has often been the basis for facilitating restructurings and new money packages for the major debtor countries.

Part of the Bank's role in catalyzing external finance has been informational: the Bank attempts to keep creditor groups -- including bilateral lenders, credit insurers, and commercial banks -- up to date on the adjustment programs, prospects, and financing needs of individual countries. The Bank has also provided ongoing technical advice to the countries regarding the design of economic policies as well as the calculation of financing needs.

In addition to this role of technical advisor, the Bank has used other mechanisms to stimulate lending to countries that have adopted appropriate reform programs. Parallel financing has been used by the Bank to encourage commercial banks to provide additional new money for major debtor countries implementing reform programs. Under a parallel financing program, commercial bank disbursements are generally linked to disbursements under World Bank loans.

In exceptional circumstances, the World Bank has also used credit enhancement techniques, such as guarantees, to provide some financial support under the debt strategy. In each of these instances, it was determined that the enhancements were necessary to help complete new financing packages which catalyzed significant additional financial flows from other sources. These techniques have been used with caution by the Bank -- and only in a limited number of cases -- in order to preserve the leverage they have on private financing, as well as the Bank's own financial standing.

We believe that the major focus of the Bank on helping countries pursue structural adjustment and achieve growth in order to ease their debt burdens has been appropriate. However, we also believe that further measures should be taken to release resources for growth in reforming countries through reducing their debt and debt service burdens. In this context, we discuss below U.S. ideas about the use of World Bank and IMF resources from current capital to support debt reduction.

A number of other economic and resource concerns have played an increasing role in the Bank's efforts to promote long-term growth in the Highly Indebted Countries, as well as in other countries. The Bank monitors carefully the impact of adjustment programs on the poor. Deliberate efforts are being made to mitigate the costs reforms impose on such vulnerable groups. Furthermore, such groups are now being recognized as economic actors who can potentially contribute to growth. The role of women in developing economies is also receiving greater attention. In many countries, various factors constrain the ability of women to participate in the economy. Better training and access to economic opportunities can help these groups increase their productivity.

The Bank is also taking greater care to consider the impact of its projects on the environment. The future economic potential of developing countries depends in part on the well-being of their natural environment, and the Bank now recognizes the need for countries to pursue conservation and environmental planning. The United States has been encouraging the Bank to integrate environmental concerns more thoroughly into the project cycle, particularly at the earlier stages, and to develop better procedures to assess the environmental impact of the projects they fund. We are working with other member countries of the Bank to improve policies in a number of areas such as access to information, outreach to non-governmental organizations in borrowing countries, and greater sensitivity to the need to protect fragile eco-systems such as tropical forests and wetlands.

By addressing these special concerns and helping countries undertake effective structural reforms, the World Bank seeks to facilitate and nurture long-term, sustained growth in developing countries, thereby easing the burden of their debt.

The Bank's Strategy in Other Seriously Indebted Countries

The need for realistic, comprehensive, and well-implemented adjustment programs to ensure recovery and sustained growth also guides the Bank's work in other seriously indebted countries. This is particularly true in the case of the low-income countries of Sub-Saharan Africa. The major difference in Bank strategy for this group of countries is that less emphasis can be placed on the mobilization of resources from private financial markets. Rather, Bank efforts center on official financial support for such countries, since the bulk of exposure in these countries comes from official creditors.

As mentioned above, investment lending remains the primary activity of the Bank. The role investment projects play in building infrastructure and enhancing the physical and human resource base is particularly important for long-term growth and development in the least developed countries. However, macroeconomic and structural adjustments are also critical to restoration of growth in these economies.

Financing adjustment programs and other resource needs in the least developed countries has presented a challenge to the Bank and the international community. Special mechanisms to mobilize and coordinate financing efforts have thus been created. These rely on the adoption of internationally accepted adjustment programs as criteria for eligibility. The World

Bank, through its International Development Agency (IDA), plays a major role in providing financing from its own resources and in serving as a catalyst for financial support from other sources for economic adjustment programs in the poorest countries.

In this regard, the World Bank has taken the lead in developing a Special Program of Assistance to increase disbursements for low-income Sub-Saharan African countries implementing economic reforms. World Bank support is provided through IDA, and the Bank encourages donors to increase concessional resource flows through cofinancing arrangements with the Bank. Country eligibility is defined in terms of commitment to and implementation of economic reform programs. In particular, Policy Framework Papers -- designed to describe borrower objectives over a three-year period and drawn up with the assistance of the IMF and World Bank -- play an important role by providing consistent guidelines for growth-oriented adjustment and resource mobilization through the programs described above and the IMF's Enhanced Structural Adjustment Facility.

SECTION III: Progress and Recent Developments

The Highly Indebted Countries have progressed at various rates in their pursuit of recovery and sustained economic growth. Even in the best conditions, correcting the serious macroeconomic imbalances that had accumulated in these countries must be recognized as a long-term process. Success in achieving balanced macroeconomic conditions and a healthy economy depends heavily on the ability of individual countries to sustain adjustment efforts. In reality, individual countries have shown different degrees of dedication: while adjustment efforts have remained strong in some countries, they have faltered in others. This variable commitment to reforms has affected growth as well as access to external finance.

The attached (Table 1) highlights the aggregate performance of the fifteen major debtors since 1981.[3] Aggregate GDP growth for this group has improved from -0.5 and -2.7 in 1982 and 1983 to 3.8% in 1986, 2.5% in 1987, and 1.5% in 1988. It should be noted that data for GDP growth in 1987-88 are heavily influenced by a sharp reduction in Brazilian and Argentine growth. Excluding Brazil, growth for the group increased from 1.6% in 1986 to an estimated 2.6% in 1988.

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[3] As published in the IMF World Economic Outlook, October 1988. The fifteen major debtors include Argentina, Bolivia, Brazil, Chile, Colombia, Cote d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia; the World Bank adds Costa Rica and Jamaica to complete the list of Highly Indebted Countries.

Trade statistics provide another indication of the economic recovery and growth potential in debtor countries. The value of exports sold by the major debtors rose by 12% in 1988 and is expected to continue to rise (by 8%) in 1989. The value of imports for the group increased by 10% in 1988, and projections show that it will continue to rise at that rate in 1989.

Some progress has been made in recent years in easing the external debt burden of the major debtors. The major debtors' aggregate ratio of debt to Gross Domestic Product fell in 1988 and is expected to continue its decline in 1989. The group's debt/exports ratio has dropped by 11% since reaching its peak in 1986.

Furthermore, the ratio of debt service to exports in 1988 stood 18% below its 1982 level, and the IMF projects that this indication of the ability of debtors to service their debt will continue to show improvement in 1989. Debtor countries have been able to make this progress in reducing their debt service burden through continued improvement in export performance -- despite rising interest rates, which have tended to cause an increase in debt servicing obligations. The aggregate interest/export ratio for the fifteen shows similar improvement, although the 1987 and 1988 figures are heavily influenced by Brazilian interest arrears and repayment of those arrears.

The experiences of several countries that have in general adopted and implemented strong reform programs is illustrative of the progress achieved in promoting long-term growth and reduced debt burdens in the major debtors.

Chile, for example, has undertaken intensive policy reforms. These reforms reach across the Chilean economy, promoting greater efficiency and competitiveness. Chile has the most open investment regime in Latin America. Reforms in other areas have yielded particular progress in rehabilitating the financial and corporate sectors and liberalizing the trade regime. Because of these and other adjustments in its economic management, Chile has benefitted from real growth exceeding 5 percent for the past three years. Inflation has also been reduced to a very low level. The country's debt/equity swap programs have also reduced its existing external obligations by almost $6.5 billion.

Colombia is one of the most successful adjusters in Latin America and has avoided any formal debt rescheduling during the region's debt crisis. Colombia carried out far-reaching structural reforms in 1985 and 1986 under IMF "enhanced surveillance," while simultaneously undertaking reforms in its trade and agricultural sectors. The country has subsequently: reduced its fiscal deficit to less than 3 percent of GDP in 1988; reformed its tax system to increase equity, efficiency, and collections; and increased its international competitiveness through a more liberal foreign trade and exchange rate system. The reward has been GDP growth averaging over 5% in the 1986-88 period.

Since 1982, Mexico has been pursuing a reform program that emphasizes trade liberalization and includes public enterprise reforms, reductions in and better targeting of food and credit subsidies, greater receptivity to foreign investment, and tax reform. In further efforts to stabilize the economy, Mexico adopted in December 1987 an Economic Solidarity Pact, followed by the Pact for Stabilization and Economic Growth in 1988. These programs have significantly reduced inflation from its recent high levels. Mexico has also engaged in extensive privatization, reducing the number of state-owned enterprises by over 50%, although much remains to be done to improve the efficiency of remaining parastatals. Earnings from non-traditional exports, moreover, have increased substantially in response to efforts to diversify exports. However, declining oil prices have impeded the benefits in terms of growth that Mexico should be experiencing as a result of its sweeping reform program.

Adjustment efforts have also helped Morocco to increase exports, eliminate its current account deficit in 1988, and limit inflation to a moderate level. Structural reforms underway include measures to liberalize Morocco's foreign trade and price regimes, rehabilitate the financial sector, and

improve public enterprise management. Although Morocco suffered a slowdown in GDP growth in 1987, the economy achieved a healthy level of growth in 1988, and its future prospects are quite positive.

The Philippines has also taken on a serious reform program. The tax system has been restructured; trade liberalization has significantly opened the economy; the financial sector has undergone restructuring; and a program to privatize government-owned assets has begun. The Philippines has subsequently experienced GDP growth well above the average for the major indebted countries. In order to sustain growth, current reforms need to be continued, and further efforts need to be made in areas such as exchange rate policy.

However, despite accomplishments to date, we must acknowledge that serious problems and impediments to a successful resolution of the debt crisis remain. Clearly, in many of the major debtor nations, growth has not been sufficient. Nor has the level of economic policy reform been adequate. Capital flight has drained resources from debtor nations' economies. Meanwhile, neither investment nor domestic savings has shown much improvement. In many cases, inflation has not been brought under control. Commercial bank lending has not always been timely. The force of these circumstances has overshadowed the progress achieved. Despite progress, prosperity remains out of reach for many.

The growth of per capita gross national product (Table 2) provides one indicator of the impact of economic growth on national populations. However, equity[4] might be better measured by looking at how an economy distributes the benefits of economic growth. Because distribution of economic benefits and income within a country is determined by domestic policies (and politics), economic equity is not an issue easily addressed by adjustment programs. Nonetheless, by attempting to disassemble distortions in economies, such as subsidies that disproportionately benefit the middle classes, adjustment programs do tackle some distribution issues. For instance, the removal of price ceilings on agricultural goods affords farmers a better opportunity to profit from their goods and provides more realistic incentives to production. Some strides can also be made by the Bank through poverty alleviation and other development initiatives. However, the responsibility for equitable growth rests with each country.

The overall sustainability and equity of growth achieved by individual debtor countries is difficult to determine. As reforming economies experience sequential years of significantly positive growth, they become more likely to succeed in sustaining a healthy level of growth over the long term. Much depends, however, on the continuation of good economic policies.

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[4] H.R. 4645 directs the Secretary to describe debtor countries' success in achieving sustainable and equitable growth as measured by criteria such as per capita income.

In attempting to draw overall conclusions about the drain of debt servicing on debtor economies, some analysts have used net financial transfer figures to assess the amount of capital developing countries are exporting to the industrial world. However, calculation of these variables has been a source of controversy in the field of international economics and finance. Some sources confine these terms to the parameters of international financial markets. They define net flows (i.e., net lending or net disbursements) as actual disbursements less principal repayments, while describing net transfers as net disbursements less interest payments -- which will, of course, reflect a substantial negative outflow. One such calculation estimated net transfers on long-term debt to the 17 Highly Indebted Countries at approximately $-11 billion in 1987.

Other analysts (the Organization for Economic Cooperation and Development (OECD), for example) look more carefully at the economic significance of these terms. Such analysis reveals that net financial transfers are intended to identify the resources available to a national economy to expand domestic consumption and investment beyond the level of national output.[5] As a result, data prepared by the OECD and others include official development assistance (ODA) and private investment in a developing economy as contributors to the concept.

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[5] Organization for Economic Cooperation and Development, Development Cooperation, 1988, pp. 52-55.

Table 3 illustrates the method used by the OECD for calculating net resource flows, which serve as a guideline for deriving net financial transfer estimates. These figures represent flows to all developing countries. It should be noted that Sub-Saharan African countries tend to receive more ODA than do major debtor nations and that some of the Asian countries make more substantial negative transfers abroad without overburdening their economies. Nevertheless, the OECD calculation of net resource flows offers some indication of the discrepancies involved with differing definitions. While total resource flows to developing countries have declined in the 1980s, they remain positive: approximately $89.1 billion in resources flowed to the developing world in 1988, according to the OECD. Drawing from these figures, the OECD has calculated net financial transfers (Table 4). The OECD estimate of net financial transfers to Latin America in 1987 is negative $4 billion, compared to the negative $11 billion figure cited above.

The remaining point to be made about the flow of financial resources is that neither net inflow nor net outflow can be definitively labelled beneficial for developing countries. While the inflow of financial resources to a developing country can allow it to expand consumption and experience greater investment, the existence of inflows is not necessarily a positive indicator for the country's economy and its potential for sustained growth. Large positive inflows in the late 1970s and early 1980s, for instance, portended financial and

economic trauma for many developing countries in the following years because of their inability to service fully the large debt component of these flows. On the other hand, the flow of financial resources out of a developing country -- like that South Korea is now experiencing -- can indicate that the economy is highly productive and reflects a normal process in which a country moves from a net debtor to a net creditor position.

Debt Reduction

Debt reduction offers a potentially powerful tool for debtor nations to redress negative capital flow problems. A number of Highly Indebted Countries have pursued debt reduction with their commercial bank creditors via market mechanisms. These options include debt/equity swaps and other debt conversions, exit bonds, cash buybacks, and debt exchanges. Such voluntary debt reduction measures have already achieved substantial success in reducing both debt and debt service burdens.

During the past four years, various voluntary debt reduction techniques have reduced by more than $26 billion the external debt that the 15 major debtor countries owed to commercial banks. As shown in Table 5, nearly half this reduction was from debt/equity swaps ($12.5 billion). In addition, commercial banks have undertaken some $7 billion in private debt restructurings (primarily in Mexico) and over $6 billion in other types of swaps, including informal conversions and the 1988 Mexican debt/bond exchange. The vast bulk of these arrangements ($26 billion) have been made in the past two years, with more than $18 billion in 1988 alone.

The most recent example of negotiated debt reduction is found in the financial package agreed by Brazil and its commercial bank creditors. This package was the first to combine substantial new money with significant debt reduction, illustrating that these two financial techniques are not mutually exclusive. The package includes $5.2 billion in new money to support Brazil's economic program, including structural reforms, to mid-1989. The debt reduction component of the program allows larger banks to improve, through exit bonds, the risk profile of their portfolios while eliminating future commitments to new money or restructuring arrangements. In the Brazilian package, each bank was allowed to acquire up to $15 million in exit bonds, bearing interest of six percent per year.

The maximum amount of exit bonds provided for in this program was $5 billion. Initially, bank analysts estimated that these exit bonds, along with other debt reduction provisions and existing conversion programs, had the potential to reduce Brazil's external debt by more than $18 billion (net) between 1988 and 1993. If it were to take full advantage of this opportunity, Brazil could save $5 billion on future interest payments.

However, in recent months Brazil has suspended its relending program for one year and its debt-equity swap program on a more temporary basis. If these suspensions continue, they could delay debt reduction under this program. Nevertheless, the program clearly underscores the ability of debtors and commercial banks to work out agreements with diversified new money and debt reduction components. Linkages to the World Bank and IMF continue to offer important mechanisms for facilitating such agreements.

SECTION IV: Suggestions for Strengthening the Current Approach

The Administration has undertaken a major review of the international debt situation in order to assess progress and shortcomings of the current strategy. Our review reaffirmed the viability of the key principles of that strategy:

- Growth is essential to easing debt problems;
- Economic reforms are necessary to achieve such growth;
- Debtor nations have an ongoing need for external financial resources; and
- Solutions to debt problems must be pursued on a case-by-case basis.

On the other hand, the review confirmed that serious problems and impediments to a successful resolution of the debt crisis remain. In many debtor nations, growth has not been sufficient, nor has economic policy reform been adequate. Capital flight continues to drain resources from debtor countries' economies, and neither investment nor domestic savings have shown much improvement. Furthermore, while some progress has been made in reducing countries' debt through market mechanisms, the pace of debt reduction has been constrained by the sharing and negative pledge clauses in commercial bank agreements.

As a result of these ongoing problems and shortcomings of the current approach, we have concluded that additional measures are needed to address international debt problems.

In developing new ideas to confront this situation, several objectives have framed our thinking. Experience has shown us that financial resources are scarce, and we feel that they need to be used more effectively. In addition, we strongly believe that the international financial institutions should retain central roles in the debt strategy. Measures must also be taken to preserve their financial integrity and to minimize the cost or contingent shift in risk to creditor governments and taxpayers. At the same time, our review has convinced us that the international community must encourage debt and debt service reduction, while continuing to recognize the importance of new lending.

As a result of our review of debt problems, we have made specific suggestions about how debt problems might be better addressed.[6] First and foremost, the international financial institutions should continue to promote -- through advice and financial support -- economic policy reforms. Revitalized new investment, strengthened domestic savings, and the return of flight capital should receive particular emphasis, since progress in these areas can help countries to finance their own growth. We hope that the Bank will use available tools, specifically SALs and SECALs, to promote policies that encourage direct investment and bring flight capital home. Such adjustment and revitalization of debtor economies through World Bank and IMF programs should also continue to serve as a catalyst to new financing.

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[6] These ideas were presented by Secretary Brady in a speech before the Brookings Institution and Bretton Woods Committee, March 10, 1989.

Further steps need to be taken, however, to mobilize more effective and timely financial support from the creditor community. In brief, commercial banks need to work with debtor nations to agree on a broader range of alternatives for financial support, including both debt and debt service reduction and new lending mechanisms. To facilitate the debt reduction process, constraints on diversified forms of financial support need to be relaxed. In particular, the negotiation of a general waiver of the sharing and negative pledge clauses for each performing debtor could permit debt reduction negotiations between debtors and banks which choose to pursue this alternative to go forward. Such waivers might have a three-year life, to stimulate debt reduction within a relatively short time period. We expect these waivers to accelerate the pace of debt reduction, passing the benefits directly to the debtor nation.

Other steps will also be necessary to address debtor countries' financing needs. New lending will be encouraged as creditworthiness improves and differentiations are made between new money and old. Efforts will also be made to provide more timely and flexible financial support, while maintaining the close association between economic performance and external financial support.

The World Bank and IMF can support and encourage the debt reduction process by redirecting a portion of the funds which they currently have available. Negotiation of debt or debt service reductions should remain in the marketplace, rather than under the management of the international financial institutions. However, specific measures can be taken to promote debt reduction arrangements. For instance, the World Bank and IMF could redirect a portion of their policy-based loans for use to support specific transactions. These could include financing to collateralize debt-for-bond exchanges with a significant discount on outstanding debt, or to replenish foreign exchange reserves following a cash buyback.

The World Bank and IMF could also provide additional financial support to back a portion of interest on transactions involving a significant reduction of principal or a major reduction in interest rates.

These suggestions for a greater World Bank role in facilitating debt reduction are fully consistent with the intent of Congress as expressed in H.R. 4645. Discussions of these ideas are underway with other creditor governments and have been initiated with other World Bank Executive Directors. The details of our suggestions for strengthening the current debt strategy will have to be worked out through further consultations in the IMF and World Bank with other creditor and debtor governments, and with commercial banks.

TABLE 1

AGGREGATE PERFORMANCE IN THE FIFTEEN MAJOR DEBTORS

	1981	1982	1983	1984	1985	1986	1987	1988	1989
GDP Growth (%)	0.1	-0.5	-2.7	2.3	3.8	3.8	2.5	1.5	3.4
Export Values ($ billion)	127.0	112.2	111.1	123.4	118.8	99.4	112.5	126.2	136.3
Import Values ($ billion)	133.6	108.2	82.8	80.4	78.2	78.7	86.1	94.7	105.2
RATIOS, in percent:									
Debt/exports	202.4	267.8	290.8	271.7	289.6	347.9	336.7	308.3	293.7
Debt/GDP	37.8	42.3	46.5	46.0	46.0	47.4	49.7	47.2	44.9
Debt service/ exports	38.9	49.8	39.5	39.9	38.8	43.3	34.6	41.0	38.8
Interest service/ exports	22.7	30.9	29.2	29.3	28.5	27.9	21.5	26.1	25.2

** Entries for 1988 are estimated; entries for 1989 are projected.

SOURCE: International Monetary Fund, World Economic Outlook, October 1988

It is our hope that these ideas for revitalizing the debt strategy will receive the support and attention of the international community and that all parties will move forward to facilitate progress in addressing debt problems.

TABLE 3

TOTAL NET RESOURCE FLOWS TO DEVELOPING COUNTRIES

Current $ billion

	1979	1980	1981	1982	1983	1984	1985	1986	1987
I. OFFICIAL DEVELOPMENT FINANCE (ODF)	36.9	45.1	46.6	44.0	41.8	47.1	48.5	56.2	59.3
Official Development Assistance (ODA)	31.1	37.3	37.9	33.7	33.3	34.4	36.9	44.4	48.1
Other ODF	5.8	7.8	8.7	10.3	8.5	12.7	11.6	11.8	11.2
II. TOTAL EXPORT CREDITS	13.5	17.0	17.2	13.6	7.4	7.1	4.6	-0.3	-0.7
III. PRIVATE FLOWS	54.0	66.1	74.5	58.4	48.0	33.5	30.9	26.1	30.5
Direct Investment	13.4	11.2	17.2	12.8	9.9	11.4	6.7	12.2	20.0
Int'l Bank Lending	35.9	49.0	52.0	37.6	34.1	17.4	13.6	5.2	5.0
Total Bond Lending	x	1.5	1.5	5.0	1.1	1.0	4.8	1.6	0.5
Other Private	2.7	2.0	1.8	0.7	0.6	1.1	2.9	3.8	1.5
Grants by Non-governmental Organizations	2.0	2.4	2.0	2.3	2.3	2.6	2.9	3.3	3.5
TOTAL NET RESOURCE FLOWS (I+II+III)	104.4	128.2	138.3	116.0	97.2	87.7	84.0	82.0	89.1
Related data:									
Use of IMF credit, net	x	2.6	6.1	6.2	12.5	5.4	0.8	-1.4	-4.7

Note: 1987 data are provisional

SOURCE: Organization for Economic Cooperation and Development, Development Issues, 1988, p. 47.

TABLE 2

GNP PER CAPITA

	In U.S. Dollars		Real growth rate (percent)	
	1986	1987	1980-87	1986-87
Argentina	2360	2370	-1.9	0.2
Bolivia	510	570	-5.4	0.3
Brazil	1830	2020	1.0	1.5
Chile	1310	1310	-1.8	3.6
Colombia	1260	1220	0.6	3.4
Costa Rica	1510	1590	-0.9	0.5
Cote d'Ivoire	700	750	-3.0	-5.9
Ecuador	1130	1040	-1.9	-7.9
Jamaica	870	960	-2.5	4.5
Mexico	1900	1820	-1.6	3.0
Morocco	580	620	0.5	-1.3
Nigeria	700	370	-5.0	-7.7
Peru	1150	1430	-1.1	5.9
Philippines	560	590	-3.3	3.1
Uruguay	1920	2180	-2.3	4.4
Venezuela	3850	3230	-2.3	0.0
Yugoslavia	2300	2480	0.0	-2.1

Source: The World Bank Atlas 1988

TABLE 5

DEBT REDUCTION BY CATEGORY, 1985-88

Debt/Equity Swaps	$12.5 bn
Private Debt Restructuring	7.0 bn
Repatriation of Flight Capital via Swaps (Chile)	2.1 bn
Informal Debt Conversions	5.0 bn
Debt/Bond Swap (Mexico)	1.1 bn
Cash Buybacks (Bolivia and Chile)	0.6 bn
TOTAL	$28.3 bn

SOURCE: Treasury estimates

TABLE 4

NET FINANCIAL TRANSFERS

Current $ billion

	1979	Average 1980-82	1983	1984	1985	1986	1987
Sub-Saharan Africa	12	12	10	8	10	13	16
North Africa and Middle East	16	9	5	7	8	6	4
Asian LICs	10	12	12	14	17	17	22
Other Asia	5	6	9	1	-3	-2	-2
Western Hemisphere	28	30	-8	-8	-15	-10	-4
Other and adjustments*	7	8	-2	5	3	3	-2
TOTAL DEVELOPING COUNTRIES	78	77	27	27	20	27	34

* Europe, Oceania, unallocated and other adjustments

SOURCE: OECD, Development Cooperation, 1988, p. 53.

DEPARTMENT OF THE TREASURY

Interim Report to the Congress
Concerning
International Discussions on an
International Debt Management Authority

March 1989

Interim Report to the Congress
Concerning
International Discussions on an
International Debt Management Authority

Legislative Requirements

Section 3111 of the Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418) (the Act) requires the Secretary of the Treasury to study the feasibility and advisability of establishing an International Debt Management Authority (the Authority) to purchase and restructure the sovereign debt of less developed countries. According to the provisions of the Act, in studying the feasibility and advisability of establishing the Authority, the Secretary may determine that the initiation of international discussions on the establishment of the Authority would:

-- cause a material increase in the discount on sovereign debt,

-- materially increase the probability of default on such debt, or

-- materially enhance the likelihood of debt service disruption.

If such determination is not made, the Secretary must initiate discussions with those countries he determines to be appropriate for the purpose of establishing the Authority. The Secretary must include in interim reports to the Congress an explanation in detail of the reasons for the determination.

Section 3112 of the Act requires the Secretary of the Treasury to review all potential resources available to the International Monetary Fund (IMF) and the World Bank which could be used to support the creation of the Authority and to direct the U.S. Executive Directors of the International Monetary Fund and World Bank to determine the amount of, and alternative methods by which, the IMF gold stock and World Bank uncommitted liquid assets could be pledged as collateral to obtain financing for the Authority.

The Act requires two interim reports on the progress being made on the study or in international discussions on establishing an Authority, as well as a final report on the study or discussions and recommendations. This is the first of the two interim reports. The second is due on August 23, 1989. The first report must also include the findings of the U.S. Executive Directors on the potential use of IMF and World Bank resources to support such a facility. This report responds to these legislative requirements.

Debt Strategy Review

The Administration has undertaken a major review of the international debt strategy. As a part of this review, we have had discussions on debt problems with the G-7 industrial countries

as well as with a number of developing countries. Both our internal review and the international discussions are designed to consider possible measures to strengthen the current debt strategy. Our focus has of necessity extended beyond the narrow parameters of Sections 3111-3113 of the Trade Act. Consequently, as a part of this review and pursuant to Section 3113 of the Act, we have approached the IMF and the World Bank to study alternative ways to deal with international debt problems.

As one element of the broader review, we have looked at a variety of proposals for an international debt facility, including the specific proposal included in this legislation. In this context, we have considered whether an international debt facility which assumes substantial risk on outstanding commercial bank debt is necessary or desirable, or whether alternative measures are available which can encourage greater voluntary debt reduction without a broad shift in risk to the public sector.

Virtually all debt facility proposals have several elements in common. Generally, they provide for the new facility to purchase commercial bank debt paper outright or to swap new securities issued by the facility for such debt, both at a discount. Some portion of this discount would be passed on to the debtor nations. Creditor governments and perhaps the IMF or the World Bank would back these transactions and assume the risk on the debt transferred to the Authority. Significant up-front costs to the participating creditor governments and international financial institutions would be involved. These would require additional budgetary expenses for creditor nations, where budgets are already constrained. Use of IMF and World Bank resources to collateralize funding for the Authority will be discussed later in this report. In addition to bearing the risk on the claims assumed by the Authority, the creditor governments (and the international financial institutions) would become contingently liable for the payment of interest due until the debt is repaid. If the facility were to issue consols (perpetual debt) to commercial banks in exchange for their claims, as in some proposals, the contingent liability for payment of interest to banks could be permanent.

The potential cost to U.S. and other industrial country taxpayers could be substantial - there is some $275 billion of commercial bank debt to the 15 heavily indebted middle income debtors[1] alone.

These proposals inherently shift the risk on developing country loans from commercial banks to the international financial institutions or creditor governments as the principal means of solving international debt problems. Several of the key industrial countries, moreover, have strongly opposed the concept of an

international debt facility and such a broad shift in risk to the public sector.

On the other hand, voluntary debt reduction measures are already occurring without the need for centralized facilities that control, manage, and possibly mandate prices for the debt reduction process. Various voluntary debt reduction techniques have reduced the external debt of 15 major debtor countries owed to commercial banks by more than $26 billion during the past four years. As shown in Table 1, nearly half of this reduction was from debt/equity swaps ($12.5 billion), to which we could add $2 billion in repatriation of flight capital by Chilean nationals for domestic investment purposes. In addition, commercial banks have undertaken some $7 billion in private debt restructurings (primarily in Mexico) and nearly $7 billion in other types of swaps, including informal debt conversions (primarily Brazilian and Argentine) and the 1988 Mexican debt/bond exchange. The vast bulk of these agreements ($26 billion) have been reached in the past two years with more than $18 billion in 1988 alone. With further encouragement from the debtor countries, the industrial countries, and the international financial institutions, the commercial banks would probably increase their participation in debt sales and debt conversions, as well as in other voluntary debt reduction techniques. There are a number of factors encouraging commercial banks to move in this direction. These factors are discussed in more detail below.

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[1] Includes Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

Table 1

Debt Reduction by Category
1985 - 1988

Debt/Equity Swaps	$12.5 bn
Private Debt Restructuring	7.0 bn
Repatriation of Flight Capital via Swaps (Chile)	2.1 bn
Informal Debt Conversions	5.0 bn
Debt/Bond Swap (Mexico)	1.1 bn
Cash Buybacks (Bolivia and Chile)	0.6 bn
TOTAL	$28.3 bn

Treasury Estimates.

Secretary of the Treasury Nicholas F. Brady recently suggested a new approach to revitalize the current international debt strategy, which if pursued could provide substantial benefits for the debtor nations through lower levels of debt, more manageable debt service obligations, smaller and more realistic financing needs, stronger economic growth, and higher standards of living in debtor nations. It is envisioned that this new approach would catalyze new opportunities for voluntary, market-based transactions and would better tap the potential for alternative sources of private capital. Several of these

potential benefits have also been put forth as justification for the establishment of an international debt facility. However, unlike in the case of a debt facility, this suggested approach would (1) minimize the cost or contingent shift in risk to creditor governments, (2) avoid mandatory prices for debt exchanges (with prices pre-set by the facility), and (3) maintain a market-oriented approach to debt restructurings.

This new approach: (1) builds upon the fundamental principles of the current debt strategy; (2) focuses international efforts on achieving more rapid and broadly based, voluntary debt reduction to ease debt burdens and improve prospects for strong growth; (3) recognizes the continuing need for new lending from the commercial banks in conjunction with voluntary debt reduction, while placing stronger emphasis on new investment flows and the repatriation of flight capital; (4) maintains a central role for the IMF and the World Bank within the debt strategy in encouraging debtor policy reforms and catalyzing financial support; and (5) redirects and increases available IMF and World Bank resources -- from their current capital stock -- to support debt and debt service reduction transactions agreed upon by the commercial banks and debtor nations as an additional spur to growth in the debtor nations.

Consequently, in the light of ongoing discussions and these ideas recently put forward by Treasury Secretary Brady on measures to strengthen the current international debt strategy, we do not believe that it is appropriate to begin formal negotiations concerning the Authority at this point. Our suggestions can produce substantial results in terms of debt and debt service reduction with less shift in risk to the public sector. Furthermore, it is the determination of the Secretary of the Treasury that such negotiations in the current atmosphere could materially depress secondary market prices and materially enhance the likelihood of debt service disruption. Indeed, past discussions of such facility proposals have contributed to domestic pressures to restrict debt/equity swap programs, which, in turn, have had a negative impact on secondary market prices. Considerations underlying this determination are discussed in detail below.

Secondary Market Prices

Prices in the secondary market are influenced by market-wide demand and supply conditions, country-specific developments, and general expectations regarding future developments. Short-term factors are clearly more dominant in determining secondary market prices than the prospects over time for individual nations to return to voluntary access to markets. This is due in major part to the lack of long-term demand for these claims. Moreover, there is a tendency for transaction prices for all of these countries to be affected by significant developments in one or

more individual countries, with insufficient market differentiation among individual countries. Chilean debt prices, therefore, can be adversely affected by Brazilian or Venezuelan actions which depress prices for external debt owed by these countries.

Estimates of the size of the secondary market in 1988 range from $15 to $40 billion, depending upon the nature of transactions being measured. Because of the nature of the market (a series of individual transactions undertaken by a variety of players with no central "market"), data on specific and aggregate transactions are not readily available. Transactions in some countries' debt paper can be rather infrequent, and as in the case of any "thin" market, the quoted price is not generally an appropriate indicator of the underlying value of the paper or even the price at which it will be sold. Quoted prices for a country's debt are for the debt paper most frequently traded, and this varies from country to country. Since the debt paper of a single debtor country is heterogeneous -- different spreads, interest rate basis, and so forth -- multiple prices for a country's debt may prevail. The average discount of 30 percent at which Mexican debt was voluntarily exchanged for new 20-year bonds last spring was substantially lower than the 50 percent discount prevailing in the secondary market for Mexican paper at that time.

Demand for debt in this market arises predominantly from debt-for-debt swaps, cash sales, and direct debt conversions into alternative instruments. Debt-for-debt swaps usually involve banks exchanging claims on one country for claims on another, although they may also involve exchanges of debt owed by different parties within the same country. These transactions may account for as much as 75 percent of secondary market activity, according to some analysts. Generally these exchanges are undertaken for portfolio or strategic reasons specific to a given bank or banks' situations: These may include a desire to concentrate holdings in countries where the bank has strategic business interests, or to diversify holdings to spread risk.

Cash sales by banks, on the other hand, are primarily designed to reduce or exit from LDC exposure as a means of boosting stock values and the ability to raise capital. Such sales may be made: (1) to financial institutions accumulating paper for package swaps; (2) to corporations for direct investment through debt/equity swaps; or (3) to charitable or academic institutions for environment, education or development swaps. None of these produce a direct benefit to the debtor nations, unless they end up as debt/equity swaps.

On the other hand, sales of debt to a debtor nation through direct cash buybacks reduce directly its outstanding indebtedness and debt service obligations. In spite of these advantages and their having been successfully used recently, for example, by both Bolivia and Chile, their adoption is generally hampered by

the need to get waivers from the commercial banks of the sharing clauses existing in most bank loan agreements, and this can be time consuming.

Banks also engage in direct debt/equity swaps for their own account, as well as other debt conversions such as the 1988 Mexican debt/bond exchange and Brazilian exit bonds. These instruments all convert commercial bank claims into alternative financial instruments and may involve a reduction in principal amount, a reduction in interest rates, and/or a more marketable claim. Banks may or may not continue to include these new instruments in the calculation of their LDC loan exposure.

Secondary markets for cash sales remain fairly thin, although the volume of transactions has been growing. Prices quoted reflect the most recent transactions rather than a homogeneous, highly liquid market. The final demand for debt paper, other than by commercial banks, however, appears to be primarily debt/equity swaps, underscoring the importance of debt/equity programs as a key factor in determining secondary market prices. The debtor countries themselves would be the most natural purchasers of the debt held by the commercial banks, but again, as mentioned above, they are restricted in implementing such buyback schemes by the obligation to get a waiver of the sharing clause in the bank loan agreements. Speculative demand appears to be quite narrow, perhaps in part because banks prefer to "sell" debt paper to (1) other financial institutions willing to assume any new money obligations coincident to the loans, or (2) entities anticipating specific conversions (into equity, environmental use) which may have been agreed in advance of the transaction.

Over the last two years, secondary market prices have fallen sharply. As illustrated in the accompanying chart, the weighted average price for commercial bank debt of the 15 major debtors was 68 cents per dollar of face amount in January 1987, while in January 1989, it was only 36 cents: a decline of 47 percent. As of the first of February 1989, the average price for individual country debt varied from 4 cents for Peru, the lowest price among the 15 major debtors, to 60 cents for Chile, the highest. Of the largest debtors, Mexican paper was trading at 37 cents on the dollar, during the first week in February; Brazilian paper, at 33 cents; and Argentine paper at 18 cents on the dollar. Secondary market prices for the 15 major debtors over the last two years are given in Table 2.

Table 2

Secondary Market Prices for the 15

Major Debtors' Bank Debt

(Selected Dates and in Cents per Dollar)

	1987		1988		1989	
Country	Feb	Dec	Mar	Aug	Jan	Feb
Argentina	65.0	33.5	28.0	21.8	19.5	18.3
Bolivia	9.0	11.0	11.0	10.0	10.0	9.0
Brazil	69.0	46.0	47.0	46.3	34.0	29.3
Chile	68.0	61.0	57.0	59.5	60.0	58.5
Colombia	86.0	65.0	65.0	66.5	56.0	51.0
Ecuador	64.0	36.5	31.5	21.0	12.5	12.5
Ivory Coast	77.0	40.0	30.0	26.5	19.0	15.0
Mexico	57.0	50.0	48.5	46.8	38.3	35.8
Morocco	69.0	52.0	50.0	50.0	47.0	46.5
Nigeria	36.0	29.0	28.5	27.0	19.0	21.0
Peru	18.0	7.0	5.0	5.0	5.0	4.0
Philippines	70.5	50.0	50.5	52.5	46.3	41.8
Uruguay	71.0	59.0	59.5	60.0	59.5	59.5
Venezuela	75.0	57.0	53.3	50.0	37.8	34.3
Yugoslavia	78.0	49.0	46.5	47.0	44.0	44.0
Weighted Average	64.5	46.6	45.0	43.4	35.2	32.3

Source: Salomon Brothers.

As indicated in the chart, there were two major declines in secondary market prices. The first decline of 32 percentage points largely reflected the impact of the Brazilian moratorium and substantial reserving by U.S. money center banks in early to mid-1987.

Provisioning has been instrumental in determining the banks' willingness to supply claims to the secondary market, in addition to other factors such as portfolio considerations and long-term business interests. The market discount, tax treatment, regulatory requirements, capital adequacy concerns, and accounting practices are also important. Citibank began this first wave of provisioning on May 19, 1987 when it announced that it was transferring $3 billion to its reserves for possible credit losses. This action raised its reserves to 25 percent of its exposure to heavily indebted developing countries. The remaining money center banks and some regional banks chose to follow Citibank's lead and soon built reserves up to an average of 25 percent of LDC exposure.

Smaller banks in Europe and the Middle East, according to IMF estimates, were the major suppliers of debt to the market prior to the mid-1987 increase in provisioning by major U.S. money center banks, followed by additional provisioning by Canadian, British, and Japanese banks, as well. British authorities released guidance in August 1987 on reserving against LDC claims. On December 17, 1987, the Bank of Boston signaled a second wave of provisioning by the regional banks by increasing its loan loss reserves by 54 percent. In the third quarter of 1988 the Canadian authorities issued requirements that Canadian banks should increase their provisioning against LDC claims from 15 percent to a range of 30 - 40 percent.

The second major decline in secondary market prices occurred from mid- to late 1988. Declines of over 20 percent were registered in the prices of debt of Brazil, Venezuela, Ecuador, the Ivory Coast and Nigeria. Declines of 10-20 percent were registered in the prices of debts of Argentina, Colombia, Mexico and the Philippines. Market participants have suggested that this decline was generated by adverse market psychology fueled, in part, by the impression that investment opportunities in the debtor countries were narrowing and, in part, by the regional banks selling off claims to clear their books of LDC debt by the end of the year. Canadian provisioning requirements may also have increased the supply of Canadian paper for sale. Moreover, a number of country-specific developments reflected either worsening domestic economic situations or increased rhetorical stridency within some of the key debtors which appear to have had a dramatic impact on secondary market prices. In particular, news of possible debt service suspensions, as well as heightened publicity on establishing debt facilities in the latter part of 1988, also contributed to the downward pressures on prices.

Given the importance of debt/equity swaps (and less significant so far, other debt conversions), any disruptions in the operation of debt/equity programs can have a major impact on the demand for debt in the secondary market, and hence on secondary market prices. Mexico's temporary suspension of its debt/equity swap program in early November 1987 caused the prices of its debt to drop only slightly, because demand for Mexican debt for purposes other than conversion into equity remained strong according to some market traders. However, Brazil's suspension of its debt/equity program in January 1989 may have contributed to a drop of more than 5 cents in its secondary market price.

Debt Service Disruptions

Interest or principal arrears by debtor countries can also disrupt the market, since non-payment of debt service on outstanding claims could increase the risk of holding them. Holders of these claims have the choice of either selling them immediately for whatever price possible or taking a further reduction in earnings.

The last few years offer numerous examples of debt service disruptions and associated accumulations in arrears.

Peru began limiting public external debt service payments to 10 percent of export revenues in July 1985. Since this ceiling was imposed, Peru's external payments arrears have accumulated to almost $10 billion, equivalent to over half of its current debt. More recently, Ecuador imposed a moratorium on interest payments to the commercial banks in January 1987. As a result, arrears

began to accumulate and have grown to approximately $1 billion in two years.

In February 1987, Brazilian authorities announced a moratorium on interest payments for medium-term bank claims. This moratorium generated some $4 billion in interest arrears during 1988, but was formally terminated in December 1988 with the conclusion of a new financing package with commercial banks. The new package included commitments for a broader debt/equity program (cited above) and had a positive impact on secondary market prices.

In January 1989 Venezuela decided to halt principal repayments to commercial banks to conserve reserves, pending negotiations to reopen the 1987 commercial bank rescheduling. Because of the size of their debt, both the Brazilian and Venezuelan actions further reduced secondary market values for their debt and depressed the market for Latin American debt in general.

On the positive side, Chile has maintained an open, flexible debt conversion program, implemented far reaching economic reforms and reduced inflation to nearly 10% per year, one of the lowest inflation rates in Latin America. Consequently, the secondary market for its debt remains comparatively active at prices that are the highest of the major debtors.

In addition to these countries' specific activities, broader consideration and pressures for ah international debt facility have also contributed to expectations of across-the-board debt relief and debtor actions to restrict debt/equity programs in the hope of obtaining larger scale relief without such conversions. Discussion of a series of proposals during mid to late 1988 has fed these expectations. These include, in particular, congressional discussions of debt facility proposals as part of deliberations on the Omnibus Trade and Competitiveness Act of 1988.

It has been one of the proposals actively considered by the Latin American Group of Eight[2] (G-8) which met in Punta del Este in October 1988, in part, to consider alternatives for resolving the region's debt problems. In subsequent meetings, the G-8 nations specified that a multilateral debt facility was one possible mechanism through which their objectives could be achieved.

Such discussions of the potential for an international debt facility were not the only factor affecting secondary market prices during the summer of 1988. However, when combined with the strong rhetoric warning of possible suspension of debt service in the absence of generalized debt relief and actual

suspensions of Venezuelan debt service and Brazilian debt/equity and relending programs, they clearly had a depressing effect on secondary market prices.

In sum, it is our view that the best way to respond to the concerns of Congress as reflected in this legislation and to accomplish the objectives of reducing debt and debt service burdens is through the approach recently suggested by the Secretary of the Treasury to revitalize the current debt strategy.

Potential Resources to Support an Authority

Section 3112 of the Act provides that no "funds, appropriations, contributions, callable capital, financial guarantee, or any other financial support, or obligation, or contingent support of the United State Government may be used for the creation, operation, or support of the International Debt Management Authority" without the express approval of Congress through subsequent law. The Section directs the Secretary of the Treasury to review all potential resources available to the multilateral financial institutions, particularly the IMF and World Bank, which could be used to support the creation of such a facility. As required by legislation, the U.S. Executive Directors of the IMF and the World Bank have reviewed the amounts of, and alternative methods by which, the IMF gold stock and World Bank uncommitted liquid assets could be used to support the creation of the Authority, and alternative methods for their use. Their findings are summarized below.

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[2] Members are Argentina, Brazil, Colombia, Mexico, Peru, Uruguay, and Venezuela. Panama was originally part of the group but has been excluded due to domestic political circumstances

Use of IMF Gold

Section 3112(a)(1) of the Act provides for a determination of the amount of, and alternative methods by which, the gold stock of the (IMF) could be pledged as collateral to obtain financing for the Authority. Such use of IMF gold raises a number of important legal, financial and policy issues which require careful consideration in making such a determination.

The IMF owns 103 million ounces of gold with a book value of SDR 3.6 billion (about $4.8 billion at end February 1989 exchange rates) and a current market value of roughly $40 billion. The gold represents the IMF's basic reserve and, together with other IMF assets, is available to satisfy creditors' claims on the Fund. In addition, the IMF can mobilize its gold assets to help achieve the purposes of the IMF as specified in its Articles of Agreement.

In this connection, the IMF may sell gold either at market prices, to members or the private market, or at book value (SDR 35 per fine troy ounce) to countries that were members on August 31, 1975, in proportion to their IMF quotas on that date. The proceeds from such sales can be used for regular IMF operations

(and thus is an alternative to an increase in quota subscriptions or borrowing) or to provide balance of payments assistance on special terms to developing countries in difficult circumstances.

The IMF Articles of Agreement do not permit the use of the Fund's gold as collateral for financing by a debt management authority that would be a separate legal entity independent from the IMF. Moreover, the IMF could not borrow from members or the private market using gold as collateral and provide the resources to the Authority. However, the IMF could sell gold at market related prices, with the profits made available to a debt management authority whose purposes were determined to be consistent with and supportive of those of the Fund.

A decision to sell or otherwise mobilize IMF gold requires an 85-percent majority vote of the IMF's Executive Board. Subsequent decisions on use of the proceeds require a 70-percent majority vote for regular IMF operations and an 85-percent majority for all other purposes. Moreover, under Section 5 of the Bretton Woods Agreements Act (22 U.S.C. 286c), congressional authorization would be required for the United States to support a decision to use IMF resources, including gold, for the special benefit of a segment of the IMF membership.

The provisions on mobilization of IMF gold became effective in 1978 as part of the amendment of the IMF's Articles of

Agreement. These provisions reflected an agreement which carefully balanced diverse and strongly-held views about the proper role of gold in the international monetary system, the desirability of retaining gold as a sort of ultimate IMF reserve, and the distribution of the proceeds of any IMF gold sales. The increase in the voting majority on key gold-related decisions from 70 to 85 percent was designed to assure a broad consensus and, in particular, to provide the United States, the largest member with about 20 percent of the total voting power, a veto over such decisions.

The IMF sold 50 million ounces of gold during 1976-1980 as part of the agreement on the amendments to the Articles of Agreement. However, no action has been taken to mobilize the Fund's gold since the late 1970s despite several proposals to use the gold to back a dollar substitution account and as an alternative to the 1983 increase in IMF quotas. This situation reflects the continued wide divergence of view on the appropriate use of IMF gold among IMF members and the difficulty of obtaining the 85-percent majority vote for gold-related decisions.

A decision to sell IMF gold and use the profits to support a debt management authority would reduce the resources potentially available for the IMF traditional balance of payment financing responsibilities and could accelerate the need for a quota increase and/or new IMF borrowing. At present, the IMF's financial

position is relatively strong with some $45 billion in liquid assets available for lending. However, this situation can change rapidly as occurred in the late 1970s and early 1980s. The ability of the IMF to sell gold to replenish its currency holdings provides a necessary safety net to deal with unforseen contingencies. The use of the gold for a debt management authority could necessitate earlier and larger resource additions.

A contingency that is of particular concern to the United States and other creditors relates to the role of the Fund's gold as backing for creditors' claims on the IMF. These claims arise from use of members' quota subscriptions and from loans by members to the Fund. They are considered liquid reserve assets by the member and may be used automatically, and on short notice, to acquire currencies from the IMF to meet a balance of payments need.

In the event creditors sought to encash their claims to meet balance of payments financing needs, and the IMF's available usable currency resources proved inadequate, the Fund would be able as a last resort to mobilize the gold to acquire the necessary currencies. Moreover, the creditors would have first claim on the gold should other resources be insufficient. A decision to sell IMF gold to support a debt management authority would compromise the ultimate security of creditor claims and thus the liquidity and monetary character of IMF related reserve assets. Therefore, creditors have strongly opposed use of IMF gold to expand IMF financing and are likely to resist use of the Fund's gold for a debt management authority. Indeed, some creditors have indicated that they would consider seeking early repayment of loans to the IMF in the event that the IMF's gold reserves were reduced.

Creditor claims on the IMF currently total about SDR 28 billion (at end-1988). The United States is the IMF's single largest creditor with reserve claims of roughly SDR 7.2 billion, approximately 25 percent of the total. The U.S. reserve position in the IMF also accourts for more than one-quarter of total U.S. foreign exchange reserves.

Similarly, the use of IMF gold for a debt management authority would benefit a minority of the Fund membership (for example, 39 of the 151 IMF members have restructured commercial bank debt). Other members, particularly the poorest countries, can be expected to oppose use of IMF gold for this purpose. At a minimum, these countries can be expected to press for concessions, either in terms of use of gold for them or measures to expand and ease the conditions on IMF financing to deal with their problems. This could result in actions that would hasten the need for a quota increase and/or measures that would weaken the monetary character of the institution.

As noted above, IMF support for the Authority would probably require the sale of the Fund's gold and use of the proceeds in excess of book value for the authority. Sale of the entire 103 million ounces at current market prices (about $400 per ounce) would result in profits of about $36 billion, or 15 percent of the total commercial bank debt of the middle-income debtors.

However, it is unlikely that profits of this magnitude could be realized. The gold markets are thin and volatile, and the IMF would not be able to sell 103 million ounces without depressing the gold price, perhaps drastically. In recent years, for example, the annual supply of gold from mine production reaching the market has amounted to about 50 million ounces, less than 45 percent of the total IMF gold stock. The previous IMF market sales of 25 million ounces of gold were stretched over 4 years, 1976-1980, in an attempt to avoid market disruption. Nevertheless, the price dropped by about one-third during the year following the decision to sell gold as the market positioned itself to absorb the new supplies. The United States is a major gold holder, with about 260 million ounces ($104 billion at current market prices), and a drop in gold prices would reduce the value of these holdings as well as impact adversely on domestic gold producers.

In conclusion, while use of IMF gold to support the purposes of the Authority is possible under the Fund's Articles of

Agreement, such action could pose serious risks to the IMF's financial integrity and is likely to be strongly opposed by many members. It is therefore extremely unlikely that the necessary 85-percent majority vote could be obtained for this purpose.

World Bank Liquid Resources

Section 3112(a)(2) of the Act provides for a determination of the amount of, and alternative methods by which, liquid assets controlled by the World Bank, and not currently committed to any loan program could be pledged for obtaining financing for an international debt management authority. It is our determination that there are significant financial and legal obstacles to such use of the Bank's liquid assets.

As of end December, 1988 the Bank's liquid assets (cash and short-term investments) amounted to $19.4 billion equivalent. The principal reason why the Bank holds these investments is to fund contractual lending commitments. Unlike commercial banks, the Bank typically disburses its loans over several years, so that at any point in time there is a substantial overhang of loan commitments which have been legally contracted but not yet disbursed. This overhang, the Bank's undisbursed loan balance, amounted to $43.1 billion at end December, 1988. Other contractual obligations -- for borrowers to repay the Bank and for the Bank to repay its own borrowings -- roughly balance each other. Thus

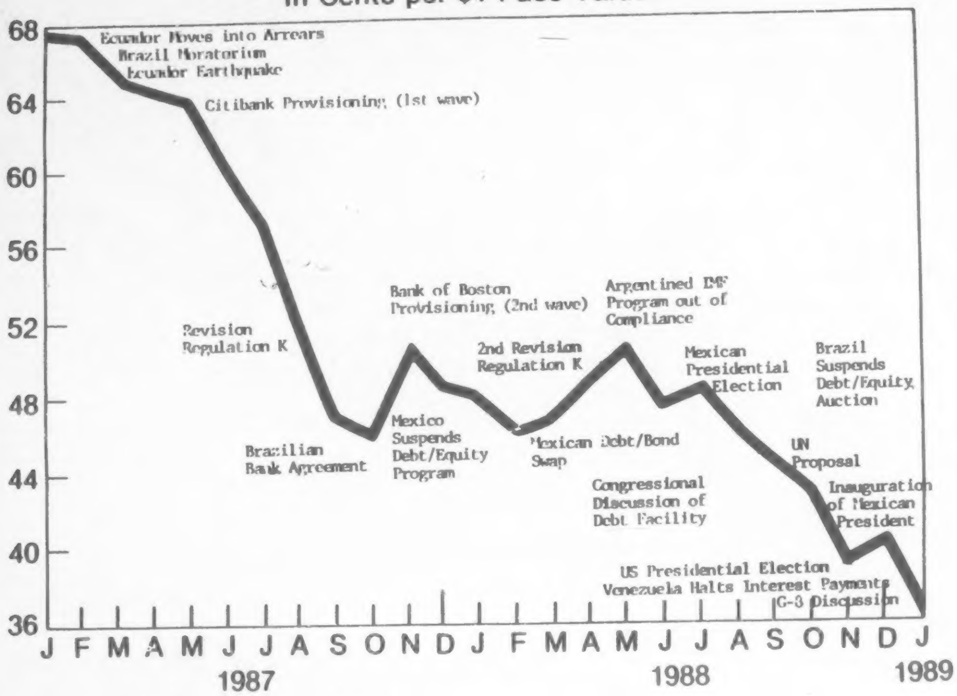
the Bank's $19.4 billion in investments are in effect already committed to contracted but undisbursed loans of over $43 billion, of which approximately $12 to $13 billion is projected to be disbursed annually over the next few years. Consequently, the Bank's liquid assets represent no more than a partial advance funding of these contracted loan commitments.

A related aspect of the Bank's level of investments is the flexibility it affords to the Bank in its funding strategy, which is heavily dependent upon borrowings in the international capital markets. That the Bank has this margin of flexibility in its need to borrow is perceived as an important element of strength by the financial markets and has been explicitly noted as such by the bond rating agencies. If a portion of those liquid assets were pledged to some other purpose, in connection with the credit enhancement of commercial bank loans, the financial markets and rating agencies would take note of the pledge and reassess the Bank's financial standing accordingly. Since the debt facility would certainly be viewed by the markets as a risky undertaking, the perceived value of the pledged assets and the Bank's creditworthiness would suffer.

Finally, the Articles of Agreement of the Bank specifically authorize the Bank to extend loans and guarantees but do not mention the pledging of the Bank's liquid assets. There are thus

SECONDARY MARKET PRICES

In Cents per $1 Face Value



Weighted Average for 15 major debtors
Source: Salomon Brothers

legal questions about the Bank's authority to enter into such a pledge transaction.

Pledges of the Bank's liquid assets could also raise questions concerning the Bank's negative pledge made in connection with its market borrowings. The Bank invariably undertakes, in support of its bond issues and other funding transactions, that it will not cause or permit to be created on its assets any mortgage, pledge, or other lien as security for bonds, notes, or other evidences of indebtedness which have been issued or guaranteed by the Bank unless the transactions containing this undertaking receives similar security. In other words, the Bank cannot pledge its assets (liquid or otherwise) to secure specific Bank obligations unless the benefits of the pledges are shared equally by the holders of all Bank debt containing a negative pledge clause.

Senator **Sarbanes**. Well, thank you very much, Assistant Secretary Mulford.

We have been joined by Senator Graham of Florida, and I will defer my questions for his statement.

Senator **Graham**. Thank you, Mr. Chairman.

Mr. Chairman, I have a full statement which I would like to ask unanimous consent to submit for the record.

Senator **Sarbanes**. It will be included in full in the record.

OPENING STATEMENT OF SENATOR BOB GRAHAM

Senator **Graham**. I congratulate you on holding this hearing to review Secretary Brady's pending proposal on a new Latin debt strategy. As the recent, tragic events in Venezuela have shown us, a pragmatic and expeditious solution to the Latin debt crisis should be a high priority of the Bush administration. The longer we go without a solution to the Latin debt, the graver the threat to democracy in our hemisphere.

Our mutual goal should be to foster an economic environment in which our Latin American neighbors can reasonably meet their debt-service requirements and have sufficient new investment to stimulate the economic growth their populations require.

Although Secretary Brady's proposal is not complete and has not yet been presented by the White House, the ideas he has already outlined for the Brookings Institution and the Bretton Woods Committee appear thoughtful and workable.

My own studies of the Latin debt crisis have led me to conclude the following:

We don't have one problem, we have a series of problems—as numerous as the countries involved.

New debt should be treated differently from old debt.

The United States needs to place its domestic financial institutions on parity with European counterparts and the United States should encourage maximum commonality and parity of treatment for Latin debt by the industrialized nations.

The United States should make it easier for Third World nations to buy back their own debt in either the primary or secondary market.

An international institution should be created—or an existing institution, such as the World Bank or the International Monetary Fund should be used—to provide loan guarantees to other international institutions or to private commercial institutions.

I find some of these ideas reflected in Secretary Brady's proposals. That signals to me that we are of like mind in wanting to resolve the crisis rapidly and with minimal risks. I look forward to hearing Mr. Mulford's testimony about debt resolution later this morning.

Mr. Chairman, to further explicate some of my conclusions about resolving Latin debt, I would like to present the subcommittee with a report from the trip I took to Venezuela, Brazil, and Argentina last spring, to study the Latin debt problem. I would direct the subcommittee's attention to the most urgent recommendations for subcommittee action during the first half of 1989, namely:

The Committee should ensure that Treasury is implementing the language set forth in the 1988 trade act on Latin debt and debt facilities.

The United States should be aggressive and pragmatic in working with Latin American nations—and international organizations such as the World Bank and the IMF—to seek resolution of the debt crisis.

Latin debt issues should be addressed at the 1989 economic summit.

The committee should hold hearings on debt/equity swaps such as those under way in Mexico and Brazil.

The committee needs to review U.S. banking and tax regulations currently applied to U.S. regulators on Latin debt issues. Those banking and tax regulations should not place our own regulators at a disadvantage compared to other international groups working to find a solution to Latin debt.

The problems of Latin debt are not insoluble problems. They can be addressed calmly and successfully. What we cannot allow is endless delay in offering constructive plans to bring debt relief to those stagnant and dangerously deteriorating economies. Latin American nations should be our partners in peace and prosperity. We have much to gain from their recovery—they are important to trade and they are critical to the sustained growth of democracy in our hemisphere. Thank you, Mr. Chairman.

Latin Debt Trip Report
to the
International Finance & Monetary Policy Subcommittee

by
Senator Bob Graham

Mr. Chairman, members of the Subcommittee, I led a group of Floridians to South America, May 29-June 6, 1988, to study the external debt issue. Upon receipt of post-trip information, I have prepared the following report.

OVERVIEW:

Our group visited Venezuela, Brazil and Argentina, where we met with finance officers, economists, and U.S. and domestic bankers to discuss Latin debt issues. What we found was debt issues could not be generalized under the broad category of the "Latin debt problem."

There is a Venezuelan problem, a Brazilian problem and an Argentine problem. Substantial differences in the economies of the three countries mean that solutions to debt problems must be independent from others. No single solution can be given to the Latin debt crisis.

The debt issue is a political and economic issue and we should therefore look for political and economic solutions. The problem grows substantially worse daily as new debt is undertaken to pay interest on old debt. Severe austerity measures and the absence of investment capital to stimulate economic growth have resulted in staggering declines in the standard of living in Venezuela, Brazil and Argentina. (Appendix I illustrates economic indicators for these countries as of June 1988.)

The United States' failure to adequately address the debt problem in these three countries is manifested in our domestic economy in several ways: decreasing exports to these countries, placing our money center banks at risk, eroding the U.S. trade position with the countries; and contributing to the U.S. budget and trade deficits.

The lack of U.S. leadership, illustrated by the passive, muddled approach taken by the Reagan Administration, affects the Latin countries adversely as well:

- Reduced standard of living and massive fiscal deficits.
- Low investment levels and reduced demand for goods in domestic markets.
- High inflation.
- Increased net export of capital.
- Reduced real income.

Politically, debt issues contribute to political tension between the United States and Venezuela, Brazil and Argentina. Our failure to resolve this issue gives Europe, Japan and the Soviet Union opportunities to increase their influence in these countries.

It appears that differences exist between the way the United States handles Latin debt compared to the Europeans. The Europeans are more flexible, acknowledging individual difficulties of these three countries. This policy engenders greater positive feelings from Venezuela, Brazil and Argentina for the Europeans.

COUNTRY-BY-COUNTRY SUMMARY:

VENEZUELA

U.S. banks claim disinterest in continuing their presence in Venezuela, but U.S. banks want Venezuelans to continue paying their debt. The Venezuelan bankers we met basically supported the economic position of their government. The Venezuelan Finance Ministry was proud of the fact that his nation was paying principle and interest on debt. The Finance Ministry was upset with the U.S. government and U.S. banks, complaining that Venezuela was being treated the same as Brazil and Argentina. (i.e., the United States was not making more capital available to Venezuela even though -- unlike Brazil and Argentina -- Venezuela has been paying its debt.)

Why couldn't Venezuela be treated differently, asked the Venezuelan Finance Ministry. Venezuela intends to keep paying its debt. However, some Venezuelans have suggested deferring part of their debt payments or paying a percentage of their debt based on their export volume, like Chile.

Venezuela is facing a liquidity problem due to the declining world price of oil. Venezuela would like more capital to ease its liquidity shortage. Venezuela's domestic programs are beginning to be impacted as the nation continues to pay its debt. The Venezuelans also expressed interest in debt/equity swaps.

BRAZIL

U.S. banks in Brazil are pleased that the Brazilian government is moving toward normal relations with the banking community and away from the debt moratorium imposed in 1987. Brazil's fourth round of negotiations with the international banking community put a restructuring package on the table which allowed a second International Monetary Fund (IMF) program and a Paris Club restructuring agreement.

Brazilian Finance Minister Mailson da Nobrega spoke at length to our group about the adverse impact on Brazil of its debt moratorium, including the unforeseen damage to its reputation in international financial circles. Brazil lost international credibility and suffered internal economic disfunctions by depleting its foreign exchange reserve, increasing the discount on Brazilian debt, reducing import capacity and slowing growth.

Mr. Nobrega also discussed how much time it took to negotiate with all the interested banking parties. Some 600 banks were involved in Brazil's most recent rescheduling.

ARGENTINA

U.S. bankers said they would continue their presence in Argentina, noting that many of them had been there a long time. However, instead of loaning new capital to Argentina as they had in the past, U.S. bankers said they would loan new capital only if it was guaranteed by the IMF or World Bank. They said Argentina needed to make economic reforms, but were unsure if politically they would be able to. U.S. bankers gave high marks to President Alfonsin and Finance Minister Sourrouille for trying to improve Argentina's financial position.

Argentine bankers we met with basically supported their government's debt position. They were very concerned about Argintina's high inflation rate. The Argentine bankers said they were interested in debt/equity swaps, but said their government was reluctant to allow many of them.

The Minister of Trade said Argentina was trying to strengthen its exports. Many products meant for local markets are being exported. The Deputy Minister of Finance spoke with us because President Alfonsin and Finance Minister Sourrouille were in New York City. The Deputy Minister described the economic program which Alfonsin was giving in New York at that time. Argentina is trying to make economic reforms, but also facing elections which could change economic polity.

Finally, we met with two leading economists, Roberto Aleman and Javier Gonzalez Fraga. They were candid about the economic structure of their country. They said Argentina had 13 years of triple-digit inflation, with the last four years featuring double-digit inflation **per month**. The economists said there had been tremendous capital flight, with local people putting their money in Argentina for seven days. Salaries are paid in dollars and the locals sell back their dollars to meet living expenses. The economists said Argentina should control inflation so capital would be invested in their country. Argentina keeps interest rates low to their creditors (Argentine banks), but makes rates high for international banks.

The economists made two final points. First, Argentina must accomplish reforms, including balancing its budget, reducing export restrictions and improving exchange rates. Second, the U.S. should provide its bank regulators more flexibility in regulatory and tax structure. U.S. rigidity does not help Argentina make economic reforms, they said.

CONCLUSIONS:

- The United States is losing its international leadership position and needs to reassert its fundamental commitment to international financial institutions.
- The U.S. needs to place its domestic financial institutions on parity with European counterparts.
- The U.S. should encourage maximum commonality and parity of treatment for Latin debt by the industrialized nations.
- Old debt should be separated from the new debt by putting a cap on the basic rate of old debt.
- The U.S. should make it easier for Third World nations to buy back their own debt in either the primary or secondary markets.
- New debt is used to pay interest on previous borrowings. This concept should be re-examined.
- Creditors should facilitate and help in enforcing structural reforms made by the countries.
- The United States should allow a positive adjustment in the economies of debtor countries, making possible continued economic growth.
- The United States should encourage a system of rewards -- not penalties -- in order to create incentives for better performance in each country. The United States should: increase lines of credit, encourage greater allowances for imports on the part of the developed countries, encourage additional loans from multilateral institutions for development of vital projects and provide guarantees from those institutions for new loans.
- At the regulatory level, particularly through the Federal Reserve Board, closer oversight of international lending by U.S. commencial banks should occur.

* In terms of new debt, an international institution should be created or an existing institution (like the World Bank) should be used to provide loan guarantees to other international institutions or private commerical institutions. This is a superior approach to get the level of funding needed in Latin America, rather than through additional international lending.
The U.S. should assign an FHA function for a loan-guarantee program with eligibility applied to Latin debt loans to particular countries, contingent on the agreement of each country to accept economic reforms that assure economic growth.

SUBCOMMITTEE INITIATIVES:

Our Subcommittee should assist in development of democracy and free enterprise in Latin America. The United States has a great opportunity to do so. The United States needs a comprehensive policy to assist the modernization of Latin America.

I recommend the following steps during the first half of 1989:

* The United States should be aggressive and pragmatic in working with Latin American nations -- and international organizations such as the World Bank and the IMF -- to seek resolution of the debt crisis. Latin debt issues should be addressed at the 1989 Economic Summit.

* The Committee should ensure that Treasury is implementing the language set forth in the 1988 Trade Act on Latin debt and debt facilities.

* Congress should re-authorize United States' contributions to the IMF and World Bank so we can continue to be involved with international considerations regarding the debt problem. The international organizations should be able to plan on U.S. contributions when bugeting debt assistance for Latin countries.

* The Committee should hold hearings on debt/equity swaps, such as those underway in Mexico and Brazil. One school of thought is that resale or reduction of debt servicing reduces demand on debtor countries. Futhermore, such exchanges could allow debtor nations to benefit from the write down of the loans and to create an investment climate that would encourage domestic and foreign capital for economic growth. Others contend that debt for equity swaps are generating new problems by creating inflation and stimulating financial speculation.

* The Committee needs to review U.S. banking and tax regulations that are applied by U.S. regulators to Latin debt issues to assure their workability and to compare them to other international regulations.

RECOMMENDATIONS BY TRIP PARTICIPANTS:

Members of our travel group suggested a comprehensive U.S. economic policy toward Latin America:

A.) Present stock of debt.
  1.) Principal: assist aggressively in long-term re-scheduling of debt held by U.S. banks (principal stretch-out in accordance with each country's debt servicing capacity).
  2.) Interest Payments: the U.S. Government would guarantee a floor of interest payments based on the cost of funds to U.S. banks.
  3.) Create a "discount window" at the Treasury for a purchasing program of present debt stock. After the discounted purchase, the debtor would service debt at the discounted price.

B.) New Floor of Financial Resources
  1.) Increase the Exchange Stabilization Fund facility at Treasury to be used as bridge loans until multilateral agencies provide additional financial resources to countries adhering to the concepts laid out in this paper.
  2.) Increase significantly authority for "soft lending" by Eximbank, including longer maturities and greater grace periods.
  3.) Expand the Insurance and Financing programs of OPIC, while reducing insurance premiums.

C.) Developing countries in the region that agree to be covered under these provisions must also undertake structural adjustment to foster growth of private-sector activities and to liberalize trade and foreign investment. This comprehensive agenda should include a significant amount of conditionality to assist in economic modernization of the region.

At present, Mr. Chairman, U.S. economic policies towards Latin America lack a comprehensive approach. The current approach is fractionalized and lacks a coherent vision and strategy. A comprehensive program such as the one outlined above would significantly assist the economic modernization of the region, with positive effects for U.S. national security and for U.S. private sector activities in the region.

APPENDIX I

Argentina, Brazil, and Venezuela: Economic Indicators

	GROSS FOREIGN DEBT (In billions of dollars)	INTEREST PAYMENTS ON FOREIGN DEBT AS A % OF EXPORTS	INFLATION CONSUMER PRICES	ECONOMIC GROWTH*	EXPORTS (In billions of dollars)
Table 1:	**Argentina**				
1983	$46.9	55%	433.7%	2.9%	$7.83
1984	$49.2	56%	688.0%	2.5%	$8.10
1985	$50.7	50%	385.4%	-4.4%	$8.40
1986	$51.7	49%	81.9%	5.4%	$6.85
1987	$53.9	48%	174.8%	1.4%	$6.35
Table 2:	**Brazil**				
1983	$93.6	42%	163.8%	-2.5%	$21.9
1984	$102.0	38%	215.3%	5.7%	$27.0
1985	$105.1	38%	242.3%	8.4%	$25.64
1986	$111.0	40%	75.5%	8.0%	$22.39
1987	$121.3	32%	374.0%	2.9%	$26.21
Table 3:	**Venezuela**				
1983	$37.7	19.75%	6.95%	-5.6%	$14.57
1984	$36.3	17.75%	18.3%	-1.4%	$15.97
1985	$35.7	23.2%	9.1%	0.3%	$14.18
1986	$34.1	27.7%	12.7%	5.2%	$8.65
1987	$33.3	20.8%	40.3%	1.3%	$10.49

APPENDIX II

RESPONSES TO THE SUBCOMMITTEE QUESTIONS

Mr. Chairman, when we went to Latin America, we took questions that were of interest to you and the subcommittee. We have recently received answers to these questions which I have enclosed for your review. The responses were drafted by the finance officer or economic officer in each country. These responses have been reviewed by the Treasury Department as well.

QUESTION 1: WHAT IS THE CAPACITY OF THIS COUNTRY TO CARRY A DEBT REPAYMENT SCHEDULE?

RESPONSES:

VENEZUELA: Debt carrying capacities of countries vary widely. Factors include natural resources, economic performance and macroeconomic and structural policies. Venezuela's debt service ratio of approximately 35-to-36 percent was higher than the average debt service of developing countries in 1987. The key to sustainable growth and better export performance by Venezuela, and thus its ability to service and reduce its debt, is more efficient use of domestic resources in public and private sectors. Macroeconomic stabilization needs to be supported by policy reform in trade, agriculture, industry, energy and human resources.

Venezuela has a poor record of economic reform. If Venezuela implemented meaningful macroeconomic, structural and sectoral reforms it would significantly improve its ability to service its debt. Venezuela has tremendous natural resources, including 58 billion barrels of proven oil reserves. As nearly 90 percent of Venezuela's export revenues are derived from sale of oil, the debt service burden for Venezuela is affected by world oil prices. Export diversification can help reduce this dependence, which has occurred in Mexico. Venezuela's capacity to service its debt may increase in the 1990s, as important projects develop in non-traditional export areas such as aluminum, petrochemicals and gold.

BRAZIL: Brazil's debt statistics are improving, as presented in Table I, which shows Brazil's external debt as a percentage of GDP and debt service ratio. External debt as a percent of GDP will fall from 48 percent of GDP in 1984 to a projected 34 percent of GDP in 1989. The debt service ratio (before rescheduling) is also improving. Brazil completed negotiations on commercial bank rescheduling in June 1988, received IMF Board approval on July 26 and a new standby agreement, and negotiated a Paris Club rescheduling last July 29.

ARGENTINA: In view of Argentina's wealth of natural resources, it could be fully capable of carrying a debt replacement schedule if the Argentine government implemented appropriate economic policies, and if world agricultural prices recover from depressed levels of most of the 1980s. Nevertheless, Argentina will continue to need significant external financing over the next several years. Sources of this external financing include the IMF, the World Bank and commercial banks.

QUESTION 2: WHAT ARE THE ECONOMIC CONSEQUENCES TO THESE COUNTRIES IF THEY MAKE THE PAYMENTS? HOW WILL THEY HANDLE THEIR BUDGETS? WILL THEY HAVE TO DIVERT RESOURCES WHICH MEET HUMAN NEEDS AND/OR DOMESTIC AND ECONOMIC DEVELOPMENT?

RESPONSES:

VENEZUELA: Commercial bank lending to developing countries grew very rapidly between 1974 and 1982, increasing the total medium and long-term debt of developing countries to promote high -- and unsustainable -- levels of domestic growth and to finance major public investment programs. With hindsight, it is clear that lending and borrowing decisions were often imprudent and that borrowing was excessive. New funds were often channeled into low-yielding investments. Consequently, if loans had been efficiently invested, the external debt problem would have been more manageable.

The need for resources to service debt forced many countries to undertake rigorous domestic adjustments. Limited access to foreign financing meant that current account deficits had to be cut back, and that trade balances had to move strongly into surplus. The need to reduce fiscal deficits and service debt meant that a higher proportion of government budgets were devoted to servicing debt. In Venezuela, debt service in 1987 amounted to 28 percent of the central Government budget.

The key to economic development (i.e., sustainable economic growth) is more efficient use of domestic resources and greater capital inflows to help finance new productive capacity. Both depend on structural reform by the debtor country.

BRAZIL: Each country must choose how it will allocate its resources. Finance Minister Mailson Da Nobrega has chosen to negotiate with Brazil's official and private creditors in order to normalize Brazil's relations with the international financial community. A commercial bank financing package has been negotiated which would provide $5.2 billion in new money this year. A number of export credit agencies, including the U.S. Eximbank, are again providing financing to Brazil.

ARGENTINA: The prime economic consequence to Argentina of servicing its external debt is to reduce the internal financial resources available to finance investment projects needed to develop the economy. Additionally, in part because of the decreasing level of trade surpluses over the past few years (a trend reversed in 1988), Argentina must obtain new external financing if it is to meet its external debt servicing requirements. Of course, this has the side effect of increasing Argentina's total external debt and relatedly its future debt service requirements.

The true budget burden of servicing the external debt is a function of the percentage of the debt financed by domestic resources compared to the percentage financed by external loans. For example, in 1987, Argentina only financed about one-fifth of the $4 billion in debt service payments. In Argentina's case, if the bulk of its external debt obligations incurred in the years immediately prior to 1982 were not used for investment of borrowed funds, Argentina's current debt burden would probably be more easily managed.

If economic growth is insufficient to enable the country to meet domestic budgetary goals as well as service fully its external debt, then choices must be made. To the extent that debt servicing is financed by external sources, this frees up domestic resources. In order to support sustained non-inflationary economic growth, a country must use domestic resources efficiently. This also implies domestic economic policies which improve the investment climate and encourage the return of flight capital.

QUESTION 3: HOW MUCH OF THE COUNTRY'S TRADE POLICY IS DRIVEN BY ITS DEBT BURDEN? HOW MUCH OF THE EXPORT SECTOR IS USED TO REPAY DEBT AND TO EARN FOREIGN EXCHANGE?

RESPONSES:

VENEZUELA: Venezuelan trade policy is driven by the longstanding need to assure adequate and diversified markets for its oil exports, which will remain the predominant income earner for the foreseeable future. The volatility of oil prices over the past several years has led the Venezuelan government to undertake projects to diversify its export base. The IMF estimates the total debt service ratio (debt to export earnings) at approximately 36 percent for 1987.

BRAZIL: Brazil is actively promoting exports to earn hard currency in order to service its debt. In 1987, net interest payments totalled $8.8 billion compared to exports of $26.2 billion.

ARGENTINA: Traditionally, Argentina (like the United States) has looked inwardly for economic development. Argentina wants to increase its exports of manufactured products only when the domestic economy is in a recessionary phase. The vast bulk of Argentina's exports are agricultural products, in which Argentina has a strong comparative advantage. The Government of Argentina's policies leading towards greater trade liberalization may be largely motivated by debt repayment obligations.

While estimates vary widely, the World Bank estimates Argentina's debt service ratio in 1987 to be 54 percent.

QUESTION 4: IF THESE COUNTRIES HAD NO DEBT, WOULD THEY EXPORT LESS AND IMPORT MORE?

RESPONSES:

VENEZUELA: Venezuela's level of imports prior to the 1987 debt crisis was unsustainable -- and the decline inevitable -- because the imports were being financed by foreign borrowing beyond the potential to service debt.

With less debt burden, Venezuela might be less pressured to produce through exports the foreign exchange to service its debt. The country might also find itself able to devote more attention to investment, and if it maintained appropriate policies, it could achieve sustainable growth. The effect of such growth on imports and exports is not clear, although it would depend heavily on trade policy, exchange rates and consumer behavior.

BRAZIL: Debt acts as a further stimulant to export and, unless economic growth keeps pace, can limit capacity to import. Increased growth would also affect Brazilian trade performance, although the exact influence of such economic expansion on imports and exports would depend heavily on factors such as trade policy, exchange rates and consumer behavior.

ARGENTINA: It is difficult to predict whether Argentina would export less and import more if it had no external debt. Some of the factors involved are: exchange rate policy, terms of trade, trade policies, inflation and other macroeconomic policies. There are clear signs that the Argentine government is moving now to liberalize the trade sector. These policies, which may be largely motivated by pressures generated by external debt repayment obligations, should lead to significant increases in both exports and imports.

QUESTION 5: WHAT ARE THESE NATIONS' PREDICTIONS OF THEIR ABILITY TO CARRY DEBT?

RESPONSES:

VENEZUELA: In 1987, Venezuela signed a 14-year public sector rescheduling agreement. Most rescheduling agreements are negotiated with both debtors and creditors aiming to ensure continued servicing of the debt. Venezuela presumably would not have accepted the agreement if it did not think the rescheduling would enable it to carry its debt. An increased inflow of money -- through foreign direct investment, bond issues, long-term project finance or increased trade lines -- could enhance Venezuela's financial position. The Government of Venezuela is encouraging the flow of new money on all these fronts via various initiatives.

BRAZIL: Brazil can service its debt under the terms of its recent debt reschedulings.

ARGENTINA: The Argentine government maintains that Argentina is in position to service regularly out of its own resources about half of its annual external debt service payments. Argentina negotiates with its creditors to reschedule external debt with the goal of continuing to service its debt commensurate with its ability to do so.

QUESTION 6: HOW CAN THE DEBT BURDEN BE HANDLED?

RESPONSES:

VENEZUELA: The Venezuelan government is encouraging the inflow of new money by various mechanisms. It has encouraged direct foreign investment by liberalizing investment regulations, particularly for large projects in high-priority sectors which generate foreign exchange. The government is attempting to return to the international bond market. Venezuela is extending repayment terms for trade credit lines. It is reviewing the possibility of utilizing some official credit programs such as the Commodity Credit Corporation.

BRAZIL: Brazil can service its debt under the terms of its recent debt reschedulings.

ARGENTINA: Argentina's debt burden can best be handled if the Argentine economy achieves a continued period of self-sustained growth. Full implementation of government policies to reform the role of the state, restructure the economy and integrate the Argentine economy into world markets -- combined with continued external financing -- offer the best hope for handling the debt burden.

QUESTION 7: WHAT IS THE ROLE OF THE PRIVATE BANKING SECTOR?

RESPONSES:

VENEZUELA: Commercial banks have traditionally been the major suppliers of credit to Venezuela. More than 80 percent of Venezuela's external debt is owed to private commercial banks. Given the refusal of Venezuela to avail itself of resources from the IMF or IBRD (due to conditionality), it is likely that Venezuela will look to commercial banks to play a predominant role in meeting Venezuela's debt needs.

BRAZIL: Private commercial banks hold approximately two-thirds of Brazil's debt. They play an important role in Brazil for trade and finance.

ARGENTINA: The Argentine government sees the role of private banks as suppliers of needed financing for debt servicing, trade financing and, in the longer term, financial lines.

QUESTION 8: ARE THE COUNTRIES TREATED DIFFERENTLY BY U.S. BANKS VERSUS FOREIGN BANKS?

RESPONSES:

VENEZUELA: U.S. banks hold more than one third of the approximately $24 billion of Venezuelan public debt outstanding. U.S. banks continue to participate in concerted lending packages at a level proportional to the banks' exposure to the country in the designated base year. International voluntary lending occurs subject to discretion of each bank, with U.S. banks more likely to remain involved in Latin America due to its proximity and market for U.S. exports there.

BRAZIL: U.S. and other foreign banks work together in their dealings with Brazil. The commercial bank advisory committee is made up of 14 banks representing the spectrum of Brazil's creditors. The committee includes representatives from U.S., French, German, British, Japanese and Canadian banks, among others. Each bank involved in Brazil continues to participate in concerted lending packages at a level proportional to its exposure to Brazil in the designated base year. At the same time, each bank engages in voluntary lending at its discretion. The proximity of Latin America and its potential as a market for U.S. exports make it more likely that U.S. banks will remain engaged in the region.

ARGENTINA: European and Japanese banks seem to be primarily interested in maintaining trade lines. U.S. banks, on the whole, participate in lending packages commensurate with the level of their exposure in the country. Several U.S. banks have longstanding operational ties to Argentina and are more likely to continue their presence in the country.

QUESTION 9: IF WE GIVE LATIN DEBTOR NATIONS ADDITIONAL ASSISTANCE, WOULD IT BE TIED TO INCREASED ASSISTANCE FOR TRADE, LIKE INCREASED JAPANESE IMPORTS?

RESPONSES:

VENEZUELA: USAID has no program in Venezuela. U.S. Eximbank lends to Venezuela, and Venezuela is required by Eximbank to tie its financing to U.S. procurement. With regard to the Japanese program for Latin America, we understand that this assistance will not be tied to procurement from Japan.

BRAZIL: The U.S. provides financing to Brazil through the Eximbank and the Commodity Credit Corporation, which are required by law to tie their financing to U.S. procurement.

ARGENTINA: USAID does not have a program in Argentina. Eximbank does provide financing tied to U.S. procurement.

QUESTION 10: ARE FOREIGN BANKS LENDING MORE OR LESS BECAUSE THEY HAVE TO HOLD HIGHER RESERVES? SHOULD WE REACH MULTILATERAL AGREEMENTS WITH ALL BANKS INVOLVED IN A COUNTRY?

RESPONSES:

VENEZUELA: Generally, bank regulators have made a start toward greater international convergence of capital measurement and capital standards, adopted July 1988 by members of the Bank for International Settlements. This is a first step, but in many countries, including the U. S., regulators allow individual banks to set the levels of their own general loan loss provisions, subject to prudential standards. Some banks many choose to have higher levels than others, based on perceptions of overall risk.

However, when banks decided to hold reserves against specific countries, or regulators mandate such reserves they no longer count as capital. They are subject to differing regulatory, accounting, and tax treatment depending on the nationality of the bank. In addition, different categories of loans may be treated differently, depending on how they are being serviced. While some convergence of reserving practices may take place, it is unrealistic to assume harmonized treatment, given the differing national rules involved. Lending decisions are based on assessment of risk, credit worthiness repayment possibilities and profitability.

BRAZIL: Bank regulators have made a start toward greater international convergence of capital measurements and capital standards, evidenced by an agreement adopted July 1988 by members of the BIS. This is a first step toward multilateral standards, but in countries such as the U.S. (and others), regulators allow individual banks to set the levels of their own general loan loss provisions, subject to prudential standards. Some banks may choose to hold higher levels of reserves than others, based on perceptions of overall risk and the bank's capital position.

When a bank assigns some portion of its reserves to a particular country or group of countries -- or when regulators mandate such reserves -- those funds no longer count as capital for the bank. Country-specific reserves are subject to differing regulatory accounting and tax treatment depending on how they are being serviced. While some convergence of reserving practices may take place, it is unrealistic to assume harmonized treatment. Lending decisions are based on assessment of risk, creditworthiness, repayment possibilities and profitability.

ARGENTINA: Some foreign banks, such as European banks, on the whole carry loan loss reserves at higher levels than U.S. banks. While the level of loan loss reserves held by a bank is one factor determining its lending policy, ultimate lending decisions also depend on each bank's existing lending portfolio to a given country, the mix of its remaining portfolio, and its assessment of risk and profitability. Other regulatory, tax and accounting considerations may also apply.

QUESTION 11: WHAT SHOULD THE U.S. GOVERNMENT AND BANKS BE DOING?

RESPONSES:

VENEZUELA: The U.S. and commercial banks should continue a flexible case-by-case approach which stresses economic adjustment by debtors and supports such adjustment through adequate financial support. All debtors stand to benefit from the current strategy. The menu of available options which are voluntary and market-based, has been expanded to facilitate debtor and creditor ability to negotiate workable financing packages.

BRAZIL: The U. S. government and private commercial banks should support countries which are working with the IMF and World Banks and are undertaking substantial structural adjustments in order to achieve sustainable growth and development and to service external debt. Now that it has committed itself to structural reforms and is engaged positively with the international financial community, Brazil is such a case.

ARGENTINA: The U.S. and commercial banks should continue to support and encourage Argentine Government efforts to restructure and reform the Argentine economy in the context of our current case-by-case growth-oriented debt strategy. This flexible approach permits lenders and creditors to select from an expanding menu of voluntary, market-based options to include in negotiated financing packages.

QUESTION 12: IF WE PROVIDE DEBT RELIEF, DO THEY THINK IT SHOULD BE CONDITIONAL TO WHETHER THEY IMPLEMENT ECONOMIC REFORMS FROM THE WORLD BANK OR THE IMF?

RESPONSES:

VENEZUELA: The only credible form of debt reduction is that which is voluntarily agreed upon by individual debtors and creditors within the context of the market. mechanisms for involuntary general debt relief or forgiveness would hinder debtor access to future credit (even short-term trade lines), could distract debtors and creditors alike from the difficult but fundamental economic adjustment talks, and risk encouraging counterproductive debt repudiations aimed at maximizing the so-called "benefits" of forgiveness. Moreover, such mechanisms could entail a shift of risk on private sector loans to the public sector and could require major expenditures of taxpayer money.

The Venezuelan government is currently of the view that no international financial transaction should be conditioned on economic reform, which is a sovereign matter. While it is recognized by some Venezuelan policing that economic reforms are necessary, they maintain that the timing and pace of such reforms is an internal matter. As a result, even IMF and World Bank funds, which are conditional on economic policy reforms, have not be available to Venezuela.

BRAZIL: Commercial bank reschedulings, which can involve some measure of debt reduction, are normally conditioned on IMF adjustment programs. Such linkage to economic reforms provides a basis for credible debt reduction in voluntary, market-based agreements between debtors and creditors. The rescheduling negotiated by Brazil within the Paris Club on July 29, 1988, adhered to this framework.

ARGENTINA: Debt relief, per se, is no panacea. Reduction in debt and debt servicing must be voluntarily worked out between debtors and creditors in order to ensure the viability of the flow of future voluntary financing needed for Argentina to develop its economy. Appropriate economic policies are also necessary if debtor countries are to establish the creditworthiness needed for voluntary lending. Any U.S. actions in support of Argentina should be conditioned on whether the government implements needed economic reforms and continues to work together with the IMF and the World Bank.

Senator **Graham**. A few comments.

First, Mr. Mulford, I am very pleased that you and Secretary Brady have come forward so expeditiously with a proposal which will elevate this debate to the level of seriousness and hopefully to expedited resolution, which it deserves.

I think it is extremely important that the issue be seen not as one of commercial relationships, but rather of fundamental strategic interest to the United States.

From my visits to Latin America over the last several years, I have seen the consequences of deteriorating economic conditions in those countries and the impact which they are likely to have on the political and social stability of our nearest neighbors.

The only surprising thing about Venezuela was that it happened in Venezuela, one of the more prosperous countries in the region.

I believe we also need to focus on what this is doing to our long-term relationships in the region. The United States has throughout its history had a special relationship with Latin America, which has been one of great benefit in terms of tranquillity and in one of expanding economic opportunities. That special relationship is now being put at risk in large part because of this Third World debt dilemma and the fact that the United States is being perceived, with some accuracy, as having been the most obstinate and least creative of the affected countries in bringing it to a resolution.

There are a number of elements that need to be included in a U.S. response, most of which you have touched upon. I would just underscore a few.

While there are some basic principles that need to be applied—and I will comment on a short list of those—one beginning point is the fact that there is no Third World debt problem. There is an Argentine problem, there is a Brazilian problem, there is a Costa Rican problem, each with its own individual characteristics, and so whatever general principles are applied, they need to operate within the sensitivity of the circumstance of individual nations.

Second is that there is quite a distinction, in my mind, between the policies necessary to deal with the existing debt and policies necessary to create an economic climate that will encourage new investment, and it is on that second part of the equation that I am concerned as to whether the plan of Treasury is sufficient and that I would like to explore.

Third is the imperative that there be economic reforms as part of dealing with this problem, but the inappropriateness of having U.S. commercial banks or the United States as a single nation be the enforcer of the achievement of those economic reforms.

It seems to me unless we are to suffer even more loss of status, prestige, and credibility in Latin America that the force for economic reform needs to be internationalized, a goal that I sense we share.

And, finally, the question of what have we learned, what has the United States of America learned through this experience, and how do we apply those lessons in avoiding a repetition?

At 10:30 we are going to start asking again those same questions relative to the S&L crisis. Those questions need to be asked here, because I think that we have made some fundamental errors in our regulatory and other public policies that have contributed substantially to this circumstance and that if there is going to be any legacy to the next set of policymakers from this experience, it should be that we are wise enough to learn by that experience and take steps to avoid or at least mitigate the chances of it happening again.

Thank you, Mr. Chairman.

Senator **Sarbanes**. Thank you.

I am pleased that we have been joined by the chairman of the committee, Senator Riegle, and I will turn to Senator Riegle for his comments.

Senator **Riegle**. Thank you, Senator Sarbanes.

OPENING STATEMENT OF SENATOR RIEGLE

First, let me say how important I feel your work is on this committee and the leadership, particularly in the last Congress with six hearings on these subjects, that you have shown has helped in finding a way to make adjustments in our policies so that we can begin to get the nations that we are talking about back into the economic stream of commerce in a way that is absolutely necessary. It is necessary for them and for ourselves and I think for the world as a whole.

I think this work is very important, and I want to indicate that this will become a major area of focus for our committee as a whole. I think that in the past, with the very strong leadership of Senator Sarbanes, that the committee needs to in a very active way support the work of the subcommittee, and we will do so. I would hope that we could work closely with the administration.

We are in that process right now, as it involves the savings and loan situation, as Senator Graham has said. We have another hearing that takes place a little later this morning that I must chair there, but I would hope that the administration would see the value, the importance, and the need of working very closely with this committee and subcommittee as new policies or efforts to move in new policy directions are developed and worked out.

I gather from my reading of the statements that Secretary Brady has made that there is an intention to make some adjustments, but the process of thinking through precisely how that is to be done and the machinery involved are still being examined.

You are nodding in the affirmative, Mr. Mulford.

I think it would be very helpful if this committee, and the others that properly have jurisdiction, could work as closely with you. We sense the need to get good results, and so, I extend that invitation for that kind of very close collaboration as we go down the track here.

Senator **Sarbanes**. Thank you. Thank you very much, Chairman Riegle.

Well, Mr. Secretary, I guess the first question I want to put to you is just how you plan to proceed from this point.

I take it that it is the Treasury's view that what the Secretary put out on Friday did not constitute a full-fledged plan. It is a proposal, it is an approach, it's very important concepts, but you now intend, in effect, to develop that in consultation with a range of both the international institutions, the debtor countries, other creditor countries, and consultations within our own society.

Is that correct?

Mr. MULFORD. That is correct, yes, Mr. Chairman.

Senator SARBANES. And how do you see that unfolding and what kind of timetable do you see this matter—what timetable are we on with respect to this matter?

Mr. MULFORD. Well, Mr. Chairman, let me emphasize one thing you said, and that is that the Secretary's speech on Friday was a speech in which he laid out certain ideas and suggestions in the form of concepts. There was some detail in the speech, but the speech was basically quite general.

We have done a great deal of work in this area, so that we have additional detail in our thinking that supports these concepts.

But we have been very careful not to lay out a blueprint which is completed in all respects because that, we think, is not really a practical way to proceed.

Yet you need enough detail for subsequent discussions to be orderly and well-focused. That is what we are going to be able to achieve.

There will be discussions at the Interim and Development Committee meetings of the IMF and the World Bank in early April.

There will be discussions within the G-7 group at the deputies level and at the ministerial level prior to those meetings.

There will be discussions at the Inter-American Development Bank annual meeting, which begins this weekend.

There will be discussions with the commercial banks, and there will be discussions within the G-10 group of countries at meetings and at Central Bank Governor gatherings which take place on a regular basis in Basle, Switzerland, and of course there will be continuing discussions here with the International Monetary Fund, the World Bank, and obviously also with Members of Congress.

Senator SARBANES. I take it the interim and development committee meetings in early April represent the really very significant forum. Well, the Inter-American Development Bank this coming week, and then the interim committees, in terms of moving a developed plan forward.

Would that be correct?

Mr. MULFORD. Yes, that's correct. One of the reasons that we surfaced these ideas now is to give ample time to the world community to digest these concepts and to prepare for the Interim and Development Committee meetings.

And our hope is that, at that meeting, there could be a constructive discussion, perhaps some general consensus that we should move further in these general directions, and then that would be followed by detailed work in the institutions at staff level and in their boards, which is necessary if the policy changes that need to be made are going to take place within the IMF and the World Bank.

So I would hope to see some considerable progress after those meetings in April.

Senator SARBANES. The Secretary indicated in his talk on Friday, and you've reiterated it here this morning, first of all, the willingness of the Japanese to provide some supportive financing.

And then he also spoke of having approached other creditor countries. And you indicate this morning favorable responses.

Is it your expectation that other creditor countries, particularly those of significant current account surpluses, will be supportive in the sense of providing additional financing along the lines of or comparable to what the Japanese have indicated?

Mr. **Mulford**. Well, we're very grateful for the Japanese statement which was issued on Friday because it had two important points in it.

One was strong support for the concepts of debt reduction and debt service reduction, which is an important statement for Japan to make, given the important role that its commercial banks play in this problem.

And, second, the reference to the provision of additional resources which we expect will be significant. We don't know the exact size yet, which we anticipate will be brought into play on a parallel basis with those in the international institutions to emphasize the aims of the plan.

Certainly, we will approach other surplus countries for similar sorts of support.

Senator **Sarbanes**. I think it's important to do that because I think the support has to be multilateral. Otherwise, it becomes a single country initiative with all of the political consequences that might result from that.

I think it's very important to make that effort.

Let me just do one other line of questioning and we'll come back for a second round. I see my time is almost up.

I notice your proposal has no sort of formal structure or process for its implementation. In fact, you say that the negotiations would continue to take place directly between the debtor nations and the banks. And I'm concerned that this will mean a continuation of the debilitating process of endless negotiation.

I mean, we've had 101 reschedulings in the last 5½ years; a tremendous amount of attention and focus is devoted to these debt negotiations rather than to economic development.

And often those efforts take months before they're—I know the Secretary spoke of trying to speed them up. And I was just interested:

Isn't there some way, given how you propose to approach it, to introduce some additional degree of coordination, I guess, in order to try to work these things out, move them along quicker, and then let the debtor country get about its business, which is to reform its economic policies, to get back on an economic growth path and sort of put the crisis to the extent that they can behind them and move on with the underlying problems?

Mr. **Mulford**. Well, I think that's a good point, Mr. Chairman.

There are important changes in methodology which we have in mind, and let me just summarize those briefly.

First of all, there are really two sets of negotiations that have to go on. One is that the country needs to determine its economic program, and it would need to negotiate its resource use with the international institutions—an IMF program, a World Bank loan.

So, that set of negotiations will go on.

At the same time, we hope the commercial banks will quickly look into the matter of how they can design and negotiate the general waivers that I've referred to.

That process would go on simultaneously with the other negotiating process I mentioned. And, ideally, if the waivers can be negotiated, they would be implemented at the same time that IMF and World Bank programs are agreed and begin to disburse.

So that debt reduction and debt service reduction activities between the debtors and the commercial banks would begin immediately; the balance of financing to be provided by investment flows, capital repatriation and new lending by the commercial banks will then follow, we hope, quickly.

But, we will not have a system of the type which we've had up until now where all sources of finance at great length and after painful and long negotiations are laid into place taking something up to a year, or even more in certain cases, while the country has a program in place but doesn't receive resources to implement its program.

That we hope to change by altering these methods.

Senator SARBANES. Well, my time is up.

Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

David, let me start by asking you a fairly simple question. I alluded in my opening remarks to the fact that the percentage of the debt held by international financial institutions, which of course the Federal Government is a major participant in and holds a major contingency liability on, has more than doubled since 1982.

No. 1, do you agree with me that this represents a transfer of the burden of this debt from the private sector to government?

And, No. 2, do you agree with me that this is something that we ought to be concerned about?

And, finally, do you agree with me that we ought to try to stop it?

Mr. MULFORD. Well, first, I do agree that, although the figures that you used somewhat overstate the case a bit because they involve certain currency valuation adjustments that overstate the figures, but I agree with the essential point that there has been some transfer of risk from private to public sources in the form of transfer to the international institutions.

Your figures confirm that and we agree with that.

Second, we think that that is something that should not go on unchecked.

And your third question was how do we propose to stop that?

Senator GRAMM. That's a good substitute for it.

Mr. MULFORD. Well, the important point I think about this proposal is that if it is true that official resources are already in use, which we all know they are in the international institutions, and if there are developments taking place as the commercial banks in a sense withdraw and the international institutions increase their exposure, we should reassess the way in which those international resources are being used.

And these proposals lay out a basis to instead of using those resources to go on adding to the stock of debt and, therefore, adding to the problem you refer to where risk is transferred increasingly, redirect those resources towards debt reduction and debt reservice reduction.

So that (a) the stock of debt does not just continue to grow; and (b) the ultimate situation is one in which the transfer of risk is slowed down and stopped.

So we believe these general concepts are exactly aimed at your objective.

Senator **Gramm**. Well, let me say that I support the effort to earmark, as the Secretary has proposed, 25 percent of the current lending to an effort to try to engage in debt reduction. And I think that's a step forward.

The concern I have is the potential call for more resources in terms of World Bank capital increases, and increased IMF quotas.

What do you think we're looking at over the next 24 months in terms of a potential call by the administration for capital increases or quota increases?

Mr. **Mulford**. I think the present capital resources of both the Fund and the Bank are ample for the purpose that we have in mind here over the next 24 months.

There is considerable liquidity in the IMF at the moment, unused resources that can be utilized in this way. And we have just had a capital increase for the World Bank, which is basically in the process of flowing into that institution.

So I don't visualize, and I think this is one of the advantages of the proposal, that whereas we have created certain additionality of resources for those debtors which are performing and take advantage of debt reduction and debt service reduction, we have not made a proposal which requires additional resources in the institutions themselves.

And I think that's a very important feature of these general concepts.

Senator **Gramm**. Let me say that I believe we have a very difficult problem. I think you have a tough job. I'm eager to try to help you.

Obviously, I think we're all concerned about what our actions mean in terms of ultimately increasing the taxpayer's exposure.

If we should reach a point that we are going to be asking for more capital and for a larger quota, I, for one, am going to want a fairly comprehensive plan as to how we intend to deal with this problem.

I think it's a problem we have to deal with. I guess what concerns me more than anything else is that the riots in Venezuela were against the reforms that we know have to take place in order for economic growth to occur—moving away from wage and price controls, which have never worked from the time of Hammurabi forward.

And we've got to find ways to encourage countries to do these things.

Let me pose one final question, then I'll quit.

If we could simply get citizens of countries in Central and South America that have capital abroad to repatriate their earnings or their capital, bring their capital back to their own country, how substantial a dent would that make in the foreign exchange problem these countries face in servicing their debt?

Mr. **Mulford**. Those are very difficult figures to be precise on. But the estimates that are generally current in the field suggest that for the major debtors the capital that is already outside of those countries, but which is owned by nationals of those countries, i.e., capital that has fled, is roughly equal to the size of the external debt of the countries.

Senator **Gramm**. So you don't think it would be an unfair statement to say that their problem is really a lack of confidence in their own economy. Because of the policies of their governments their own citizens lack confidence in their own country. In essence, the United States being one of the areas that's sort of an enterprise zone, the citizens of Third World countries are sending their capital here where it can be used more efficiently?

Mr. **Mulford**. I think that's an important part of the problem. And I think finding ways to resolve that is an important part of the solution.

Mr. Chairman, may I make one final and very short comment to what the Senator has raised about the transfer question?

I think, when we look at these issues, we have to keep in mind one important point. And that is that under the present strategies certain things are happening and it needs to be altered and strengthened, in our view.

But the point I want to make is that if we were to keep doing what we have been doing and the trend that you've elaborated were to continue, and then we were to apply additional resources to that particular strategy, the transfer of risk that you refer to would be far greater over a period of time than is contemplated under these proposals.

Senator **Gramm**. Well, I want to make it clear I'm not in favor of the status quo.

Senator **Sarbanes**. I want to ask just one quick question to get some facts out on where the burden falls.

Am I correct that the U.S. support for the IMF and the World Bank runs at about 20 percent?

Mr. **Mulford**. About 20 percent. That's right.

Senator **Sarbanes**. Twenty percent.

Mr. **Mulford**. About 19 plus.

Senator **Sarbanes**. OK. And am I correct that the debt problem, about a third of it, is on U.S. banks?

Mr. **Mulford**. About a third of the commercial bank exposure across the board is in the hands of U.S. banks. That's right.

Senator **Sarbanes**. So, to the extent you shift the burden, leaving aside other reasons why there's problems with that, you're shifting from a one-third exposure of American banks to a 20-percent exposure of the United States in the world institutions.

Would that be correct?

Mr. **Mulford**. Well, I don't think so because you have to consider not only the Fund but also the World Bank and our exposure there, which is about 18–20 percent.

Senator **Sarbanes**. That's right, but that's the percentage difference.

In other words——

Mr. **Mulford**. There's also the Paris Club, where there's official exposure and we have a percentage there, too.

But your point is that the shift is favorable, I think.

Senator **Sarbanes**. That is the point.

Mr. **Mulford**. And I don't know those exact numbers, but I think that's probably right.

Senator **Sarbanes**. The other question is:

When the Bank takes a loss on its Third World debt and writes it down and then takes that for tax purposes, what underwrite does the Bank then receive from the taxpayer? Roughly, what's the percentage, assuming the Bank is making profits?

Mr. **Mulford**. Well, it would enjoy whatever the benefit it is of its particular tax rate on its taxable income at that time for that particular loss.

Senator **Sarbanes**. But, what is that at the top rate, assuming?

Mr. **Mulford**. I don't have that figure.

Senator **Sarbanes**. It's 30 some percent—33 percent?

Mr. **Mulford**. I can give that to you. I don't have it with me.

Senator **Sarbanes**. Could you check that out, please, and let us have that?

Mr. **Mulford**. The top corporate tax rate in the United States is 34 percent.

Senator **Sarbanes**. Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman.

Alan Greenspan testified before the committee on February 21. In response to a question of "What did he believe should be the standards by which we could evaluate success or failure of any plan to deal with Third World debt?", he responded in three parts.

One, that the economic policies of the debtor nations logged back to access to financial markets on a voluntary basis.

Two, restoration of normal borrowing/lending relationships between debtor nations and the international commercial banking system.

And, three, that some of the debtor nations which have been better than others, that have, in a sense, been contaminated by the whole process—and he gave Colombia as an example of what he thought was a superior performing country—that they would find that their productive efforts would be appreciated in the marketplace.

Those were Mr. Greenspan's three standards by which he suggested a Third World debt plan should be evaluated.

Could you comment on his standards and suggest what you believe should be the standards by which the Treasury's plan should be evaluated over the next 3 to 5 years?

Mr. **Mulford**. Well, I think the standards that Chairman Greenspan elaborated are perfectly appropriate. I might state some of them slightly differently.

I think that a country that succeeds is a country that has established sustained growth, that has reformed its economic policies in important ways.

And by that I mean countries open to foreign investment, liberalized its trade regime, made important structural changes to promote growth and freer markets.

I think an important sign of success is the reversal in some way of capital flight. In other words, capital repatriation. I think that's a very important ingredient of success.

And of course a return to access to financial markets, another important sign of success.

I think, in terms of the output of any particular program of this type, it must be important that the rising stock of debt and debt service be moderated, reversed if possible, but certainly moderated vis-a-vis the growth of the economy, so that the debtor country's economy, as it makes this recovery that I have outlined, can better carry the debt burden that it has.

And these proposals, we believe, although numbers are very hard to work out, could have a rather significant impact both on the stock of debt and on the debt service level of a country that utilizes fully the ideas contained in these concepts.

Senator **Graham**. A concern about the plan, which I believe was a part of the question asked by Senator Gramm of Texas, and that is:

Why has there been this shift relatively with a high proportion of lending to Third World nations by international institutions vis-a-vis commercial banks?

One of the clear answers to that is because commercial banks haven't been lending to these countries. And whatever new capital they received has largely, therefore, had to come from the international institutions.

A concern that's been expressed about the Treasury plan is that it does not create an environment that is likely to reverse that.

Your plan, if I were the chief international lending officer for a bank that had just written off a substantial amount of its current debt to a Latin country, what in your plan would encourage you that my job security at the bank would be enhanced by coming back to the board of directors and recommending that they loan more money to that country?

Mr. **Mulford**. Well, I'd make a couple of points on that question. The first is that the banks have put up new loans, so they have made new lending decisions to these countries.

The new lending has not been of a magnitude that we had hoped.

Senator **Graham**. To what extent has the new lending exceeded the lending necessary to service the old debt?

Mr. **Mulford**. Well, the new lending levels are not as high as we had hoped at the time we crafted them.

Senator **Graham**. That wasn't my question.

The question is:

Is it not a fact that the new commercial bank lending has been no more than and somewhat less than the amount necessary to provide funds to service the old debt?

Mr. **Mulford**. That's correct in terms of the total servicing bill of the country. That's correct, yes.

Senator **Graham**. So, since the Baker plan was announced, is it fair to say that there has been no net new capital into Latin America as a product of commercial banks?

Mr. **Mulford**. Well, I was trying to outline that before. I think it might be better to say that there has been new money lent in the sense that new commitments have been made, so that a board of directors sees itself as deciding they're going to make new funds available from a bank to a given country.

But, in the meantime, banks have taken steps to create reserves, to write down debt, to sell debt in the market, enter into debt/equity swaps and so on, so that the net exposure level, which is really I think the key point, is actually over the last 3 years, when you take into account all the transactions for the major 15 debtors, is down somewhat.

So the point you're making is certainly valid, that from an exposure standpoint, the banks have been withdrawing. That's true.

As regards the incentives that you mentioned, I think that by having a 3-year program in which voluntary debt reduction and debt service reduction transactions are taking place at an accelerated pace, on a broader scale under the concepts that we've advanced and supported by resources from the international institutions, it's my opinion that major international banks will see over that 3-year period when the country is performing under its economic programs and enjoying some reduction of debt and debt service, an improving credit profile, instead of a profile of rising stock of debt and rising debt service.

And on that basis as they look at that country, and many banks have important, longstanding relationships with these major debtors, they will gain, in my opinion, considerable confidence as they see the credit profile improving over a 3-year period instead of deteriorating further.

And that I think for the sophisticated nucleus of big international banks all over the world that are engaged with these countries is a very important accomplishment to make.

Senator GRAHAM. Mr. Chairman, if I could conclude with one question.

To go back to the issue of the report card, the standards by which success will be measured.

If you were going to look at a small cluster of numbers to assess whether, in fact, the plan had achieved that objective of creating an environment in which new commercial bank lending would be made, what numbers would you look at over the next 3 years, and what would you want those numbers to be?

Mr. MULFORD. Well, I think the numbers I would look at would be country by country numbers for those countries that were engaged in this process. And I would be interested in their growth numbers, their inflation numbers, whether or not they were improving their budgetary situation.

Senator GRAHAM. No, I'm talking about the premise of your new investment strategy is that that loan officer whose just told his board of directors that we are writing off $500 million of Third World debt is now going to come back and ask them to loan an additional $250 million to that same country.

Why

do you think that your proposal will create that environment? I'm frankly skeptical. I would like to know how you are going to make a judgment over the next 3 years as to whether your optimism or my skepticism is proven out.

What numbers will you look at at the end of each quarter to give you a solace or despair as to the success of your plan?

Mr. MULFORD. Well, first of all, I wouldn't look at the end of each quarter. I would look more infrequently.

Second, I would look at two sets of numbers.

Senator **Graham**. I'm driven by impatience here.

Mr. **Mulford**. I would look at the sorts of economic numbers that I was attempting to outline, which I think will be important guides as to whether the country is performing or not in capital repatriation growth, inflation, so on. And I won't go through all of those.

But, those obviously will be an important sign of success.

Second, I would look at what is happening to the stock of debt and to the debt service figures of those countries, because to the extent that the stock of debt is reduced, but especially the debt servicing requirements are reduced, that has two effects.

One, it reduces the transfers externally that the country has to make. And, therefore, theoretically, those become available for employing further growth of the country.

And, second, by reducing debt and debt service in particular, you reduce the future new money needs of the country. And, therefore, the new financing necessities look to be much more manageable in the eyes of the commercial banks.

So those are the sort of numbers I would look at to assess progress.

Senator **Sarbanes**. Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman.

I'd like to come at this in a different way.

You would agree, I assume, that on the listing of debtor nations in the world today that the United States, in fact, is the largest debtor nation in terms of the outstanding debt that we carry.

Mr. **Mulford**. That's correct.

Senator **Riegle**. The most recent figures indicate that we are adding international debt ourselves as a nation at the rate of about a billion dollars every 3 days.

Is that roughly correct insofar as you know?

Mr. **Mulford**. Well, I'll take your word for that.

Senator **Riegle**. The New York Federal Reserve Board has estimated that early in the 1990's, we're going to owe the rest of the world as a nation about a trillion dollars. It's an interesting question as to whether there's any particular significance in reaching that milestone and going beyond it.

Most of the financial market people that I talk to are very uneasy about it. And I'm uneasy about it because it's an unprecedented circumstance for this country. We were a creditor nation going back to 1914 and as recently as 4 years ago, started to go into this tailspin.

What I'm wondering is this question:

If we continue to add international debt, does that at some point bear on our capacity to finance other debtor nations out of their difficulties?

Can we assume that even with a well-devised plan that we've got the financial capacity to, in effect, pick up a large part of the tab directly or indirectly for this problem?

Or are we finding that maybe we've got other financial problems that are building up that may actually limit the degree to which we can take an initiative, even if it's our desire to do so?

Mr. MULFORD. Well, there's really two answers I think to that question. The first is that we do have adequate resources to continue to make our contribution to the institutions that will, in turn, be dealing with this problem.

But, the other question you raise is I think a very important one to be clear about. And that is that, although we are the largest debtor, our debt is very, very different than the debt that exists in these developing countries.

First of all, as a percentage of our GNP, our debt is nowhere near the level that they're at. In other words, their debt burden is enormous in relationship to their GNP.

So their capacity to carry and service that debt is very strained. That is not true of the United States to anything like the same degree today.

Now, obviously, if any country goes on adding debt to enormous amounts forever and you move into different levels, then the problem changes. But we're not in that situation at all.

The second thing is that our debt is in our own currency. In these countries, the debt is in dollars, Deutsche marks, Swiss franks, yen, whatever—external currencies.

And the servicing and repayment of that debt in these countries which are suffering from inflation and sometimes depreciating currencies becomes an increasing burden for them because they have to generate sufficient external earnings to service and repay the external debt.

So it is a quite different problem in terms of burdens and the threat that it poses to the economy.

Senator RIEGLE. So, you see no strains on our financial capacity to be able not only to continue to assist to the extent that we have, but to perhaps even assist to a higher level?

Mr. MULFORD. No, I didn't say that because we have restraints on us in our budget, obviously, with regard to how much we can provide in the form of resources to the IMF, the World Bank, and so on. And, obviously, today, we're not in a position to put up additional funds in the way that the Japanese have agreed to do.

So there are severe limitations on us of a fiscal type.

Senator RIEGLE. I would hope that in looking at the question of how we share the arrangements of helping to finance our way out of these problems, that Japan and others, who have much more favorable financial balances at the present time, become a very important part of how we allocate the solution—the capacity to pay for the solution.

Let me ask a different but related question.

When the banks made these loans initially, they did so on their own. They were not operating at the direction of the U.S. Government, were they?

Mr. MULFORD. No, they were not. They made these loans on their own.

Senator RIEGLE. Has there been a time, any time in recent years, where the Government, in effect, has gone to the banks and said:

Look, we really expect you to hang in there and continue to either make loans or to give forbearance?

Have we had that kind of government-directed pressure on the banks?

Mr. MULFORD. We have not, no. The programs have been entirely voluntary up until now and including this group of suggestions, which also are entirely voluntary.

Senator RIEGLE. It seems to me that the banks, with their own stockholders to be accountable to and their own fiduciary relationships with guaranteed deposits, federally guaranteed deposits, face a very difficult issue as to whether or not they extend additional loans—especially with the profile of the inability of the debtor countries to repay.

I think it becomes a matter in a sense of more public policy than private policy and that, in fact, if there is a need to craft a major adjustment program, that it's being done more for public policy reasons and for reasons of the way the international economic system has to be balanced, and therefore, it is properly more and more the task of public policy.

In the sense, our Government as a whole must decide how that's to be done. I don't know that I see how we can, in effect, strongarm the banks with their other responsibilities to do things that normal practices of prudence they apply would say, "We're not going to go in any further in this kind of a situation."

Mr. MULFORD. Let me try to answer that by giving you an example that I think would clarify what one of the sort of intentions is in these concepts.

A given bank today that has a certain level of exposure to a country may not wish to extend additional credit for the reasons you have mentioned. And, in fact, it may have created reserves in lieu of possible future losses. And it may have decided that it would like to reduce its position to these countries, either by selling off some of the debt it holds, or by writing it down.

Now, in the present situation, those two transactions—an outright sale to another party or a write-down—do reduce the exposure of that bank. But they provide no benefit to the debtor country.

The debtor country continues to have a nominal value obligation to its creditors and it must service that fully.

Under these proposals, if that bank wanted to sell for 30 cents on the dollar on a voluntary basis, it would be able to, which it can't do today under the agreements. But it would be able to sell that debt back to the debtor country, for example, for the same price it can get from a third party in the market.

Therefore, the debt is extinguished and the advantage flows to the country.

The same is true in the case of a write-down. If it's going to do a write-down, it might well decide that it would enter into a swap transaction where it takes a better piece of paper back, but at a substantial discount, so the bank comes off with a better piece of paper, better certainty of servicing on that piece of paper, but at a discount. That means that that discount has flowed to the country in the form of a reduction in the stock of debt. Or, if it's an interest rate write-down instead of a principal write-down, in the form of a reduction in debt service.

The concepts here have the effect of taking what already is happening in the banks and in the markets and crafting solutions that will help those flow through to the countries.

That's an essential purpose of these ideas. And that does not involve strong-arming banks to lend more money or increase exposure or the other points that you mentioned.

In fact, it simply takes what they already are doing and allows greater freedom of action.

Senator SARBANES. Yes, I was going to suggest that maybe we should open it up and just continue along this path, because I think it's a very important line of questioning. And perhaps Senator Graham and I can join in with you.

Senator RIEGLE. Thank you. If I can, I'd like to take it another step. One of the things we ran into with the Chrysler loan guarantees was that we had to get all of the banks to agree to join the arrangement. And we found that some would and some wouldn't.

If somebody slips out the side door, it really makes it very difficult because those that step up to the burden are asked to pick up even a larger part for the person who doesn't participate.

I take it that one of the things you would hope to do here is to have everybody that's involved participating on some equal footing basis.

Senator SARBANES. Let me pursue that.

How do you address the free rider problem under the approach you're going to take, where one bank sits off on the side, continues to hold its debt at 100 percent, as other banks take something of a loss and ease the debt burden on the debtor country and try to help it get back on a growth path. The remaining debt is of course strengthened because the position of the debtor country to service it is enhanced.

In fact, it could be argued in many of these instances that if you get sufficient debt reduction at the outset on some sort of an across-the-board basis, that the debtor country can then carry the balance of the debt because it will be at a significantly reduced level and, therefore, within its servicing capacity.

So, how do you get at a bank that sort of says, "Well, I'll just sit this out. I'll let all the others make their contribution and then I'll reap the benefit of that"?

Mr. MULFORD. Well, there are really two points here. One is the degree of unanimity needed among the banks in order to make the necessary waivers that allow for the greater freedom of action in the market.

You are correct, Senator, in thinking that is a formidable job, because those provisions range, in terms of needing approval, all the way from around 50 percent to 100 percent of the banks.

However, I think that the world banking community regards this as a major international financial problem. The banks have widely diverse interests. Many banks have already reduced or eliminated their exposure. They are not, if they agreed to give a waiver, being asked to do any particular transaction or take any particular loss or whatever. They are simply allowing all the banks as a group greater freedom in allowing those banks which wish to enter into various types of transactions to do so.

And I think there is every reason, if you look around the world at the major creditor governments and their banking systems and you have adequately discussed these issues between governments, I think there is every reason to feel—and the banks, certainly many banks—feel there is a good possibility of successfully securing for some of the performing countries that are moving in the right direction the kind of waivers that are necessary.

They have already been secured in the case of Mexico, when a transaction which was done a year ago, which was a debt reduction transaction. And they have also been secured for similar operations in Chile.

So, there are precedents.

What we are hoping to do is to get the banks to agree to do a general waiver that has a lifetime of, say, 3 years, to provide a general umbrella under which a multitude of transactions would be free to occur.

As to free riders, there I think the point you make is valid. There is a problem there. And the free riders are very difficult to get at legally. And I think one has to take the following line on that.

I think one has to assume that the large banks all have diverse interests. They will wish to make decisions about reserves, write-downs, sales, debt equity swaps, and so on. And they will, in most cases, be willing to do that even though there is a small group of banks that are so-called free riders.

The free riders tend to be banks whose positions are very small, so that when you look at the total amount of money that has been lent, the total exposure, free riders may be quite large in terms of numbers of banks, but they represent a very small slice of the total financing.

So, if banks are willing to go forward, it seems to me tolerable to simply ignore the free riders for the time being, except that they must, of course, be approached to participate in the granting of the waiver. And it seems to me there is not much in the way of grounds for them to deny that approval for other banks to continue to operate, since as you point out, it is in their interests in a way if the picture improves.

I think the cost of attempting to solve the free-rider problem is disproportionate to the advantage that you get by attempting to solve it, because the solutions that would have to be used in legal terms are rather Draconian and, therefore, not terribly desirable.

Senator SARBANES. Well, I think it is something that is going to have to be followed very closely.

Mr. MULFORD. That's correct.

Senator SARBANES. You had the Bolivian buyback, and they did half of it and then they couldn't get agreement to do the other half, and then the people who sat out of the first half were then—although Bolivia may not be the best example because their condition remains so difficult in any event, but nevertheless they are in a similar strength and position.

Would it help to start thinking about requiring banks to establish allocated reserves for existing loans but not to require such reserves on new debt instruments resulting from an assisted restructuring of debt?

Mr. MULFORD. Well, those concepts have been looked at, and they have not been necessarily rejected but the general line has been that one has to be very careful in using particular instruments of that type because what we are interested here is in carrots more than sticks.

So, I think one has to balance very carefully before one attempts to go down that particular road. I am not saying there couldn't be a possibility, but I think that the present set of ideas does not include that.

Senator **Sarbanes**. Well, you may be able to get the kind of cooperation you are talking about.

Mr. **Mulford**. We may be able to.

Senator **Sarbanes**. Then, obviously, if you can get it simply through the use of carrots, that is to be desired.

Mr. **Mulford**. But one of the things about the free riders that we might find is that, unlike Bolivia, if there were a 3-year life to the wavier, there would be a long enough period for transactions to continue along and continue to be financed and you wouldn't necessarily face that transaction-by-transaction problem that the Bolivian example presented.

Senator **Sarbanes**. Senator Riegle?

Senator **Riegle**. If I may, just one other item. I have got to go and chair our other banking hearing in just a minute.

I appreciate the indulgence of both my colleagues on this.

The sense one gets is that the administration has decided to attach a much greater sense of urgency to this problem. Whatever the series of events that has brought this about, the new administration has decided as one of its immediate priorities to bring this issue into focus. The Secretary has come forward with a high-profile set of comments directed at the problem.

I would like to have you give us a sense as to why this sudden heightened sense of urgency? We obviously have been aware of what has gone on in Venezuela and some of the other things that are happening here.

But I am not just interested in what accounts for the very clear upping of emphasis and some shift in direction. I want to get a sense from you as to what sense of urgency you attach to the need to finding some ways to deal with this problem.

I get the sense that this is now seen as a matter of some very considerable need for action now. Am I reading it right or not?

Mr. **Mulford**. You are reading it as a high priority of the administration, and there is a need now to move as quickly as possible.

And one of the reasons we need to move as quickly as possible is that any period where changes are being introduced tends to reduce activity between debtors and creditors instead of financing and moving forward with solutions to problems, because they await the results of whatever they think the new proposals might be.

So, there is a need for that reason to move quickly.

But I should point out that the decision to conduct an in-depth, as it were, no-holds-barred review of the debt strategy, was made by Secretary Brady in October. And President-elect Bush, in mid-November, also indicated that he placed a high priority on this review.

We have been working steadily since late October both with members of the outgoing administration and the incoming administration, to prepare these concepts, to complete the review which I mentioned, which we have discreetly conducted around the world and here in the administration and in the Congress and among debtors and creditor nations, with a view to trying to surface these proposals at about this time.

Obviously, Venezuela is a very concerning situation, but it did not generate any new sense of urgency. The plan was to move on about this timetable and be prepared for what we hope is a key meeting in early April of the interim in development committees of the World Bank, which is where these issues will be discussed, and then further efforts will be made to make the policy changes necessary.

Senator RIEGLE. I will finish by saying that it sounds to me that what you are saying is that now, having put the issue front and center and really given it the high profile and the higher degree of urgency, that that sets in motion the very thing about which you spoke about. That is that it starts to freeze movement until everybody understands what the new game plan is.

I gather this now applies even a greater sense of time sensitivity to working through the details and hammering something out so that there clear signal. I take it that—and I don't say that in any other way than just to observe that I would think in any situation like that, once you sort of put the issue in play—now it really becomes essential to move along with some real speed.

Is that correct?

Mr. MULFORD. That is correct. And I think the movement is of two types. First, further consultation, debate, discussion, and the changing of policies in the institutions, which I have already mentioned. But there will also need to be discussions with the debtor nations that are poised to introduce new programs or have just introduced new programs, such as Venezuela, and are engaged at this time in discussions with the banks. And therefore, the working out of these details which really is a case-by-case real-time situation, will also be going forward at the same time.

Senator RIEGLE. Thank you.

Senator SARBANES. Senator Graham?

Senator GRAHAM. Mr. Mulford, when I first read about the Brady plan, what caught my attention was the suggestion that banks would be encouraged to voluntarily write down their existing debt because they would end up with a new form of debt with some international guarantee that would be more valuable than the face value of the debt that they were then holding.

Some of the comments that I have heard seem to emphasize that what is going to induce banks to voluntarily do this is the elimination of some provisions in existing lending instruments that have precluded banks from doing that they may already see to be in their interest.

Are you putting primary emphasis on that legal change, or is there also going to be a proposal for some international guarantee of a new debt instrument to replace what the banks are currently holding?

Mr. MULFORD. Well, it's a very complex set of ideas that go together, but the answer is that the legal changes are necessary but are not sufficient to success.

If waivers are agreed to, the banks would be free to enter into various transactions. It's not just a question of writing down, it's a question of exchange at a discount or it could be an exchange at par with a write-down of the interest rate to a level equivalent to the discount that would have been applied on principal, or it might be debt restructuring transactions where there is no exchange of paper but simply write-down of interest under what is called a FASB–15 type of accounting procedure for troubled debt restructuring.

The point, I think, is that once the waivers have been agreed and the situation is opened up, there would be resources in the form of the set-asides on World Bank and IMF disbursements to these countries under their normal lending programs that would be available to purchase the collateral that is used for debt swap operations.

For example, that might be zero-coupon paper that is purchased at a deep discount and used to back whatever is remaining after the discount has been accomplished.

Or it might simply be a question of the interest rate support arrangements that I mentioned also from resources in the IMF and the World Bank to support interest flows in transactions where there has been a significant write-down of the interest rate and then some limited enrolling support for that interest payment for a period of time, a backing, not a payment for it, but a backing.

It is not really a question of using guarantees in that simple sense of the word to provide guarantees on a permanent basis for one purpose or another, although in the interest support arrangement it may be that the technique would resemble very much a guarantee for 1 year of interest rolling forward for a period of time before it expires. It may never be used, but if it were used, it would be used only for 1 year of interest.

These are rather limited concepts, but they are intended to enhance in one way or another the principal and interest operations that are associated with debt reduction, and that would be seen by the banks as an incentive to help provide liquidity and finance for their—if they are interested—debt reduction operations.

At the present time there are not resources available in any great degree for these particular cases. There have been certain instances where it has happened, and a substantial amount of debt reduction has been achieved in the market, about $24 billion in the last couple of years, just in the markets alone.

But we think it's possible to accelerate and broaden that.

Senator **Graham**. Mr. Chairman, I have another line of questioning which I will hold until my next round.

Senator **Sarbanes**. That's all right.

Senator **Graham**. There are some new capital risk standards that are in the process of being implemented. I believe they are called the basal capital risk standards. What effect do you believe they will have on the willingness of banks to engage in new lending in Latin America?

Mr. **Mulford**. Well, under those arrangements the banks will be encouraged to improve or strengthen their capital positions.

As far as we are concerned, and with regard to this particular proposal, there is, I think, one important point for American banks, and that is that under those guidelines the reserves that have been set aside for LDC debt for U.S. banks, from which if they were to decide to take losses those losses would come, a portion of those reserves as of, I think it is, 1991, will no longer count as capital as they do today for the bank.

To us, this means that the banks will probably have an incentive in the next couple of years to utilize those reserves before they cease to count for capital. And utilizing them may well mean willingness to take advantage of losses that result in one way or another.

So, that could be an important source of willingness on the part of the banks to take advantage of these proposals.

Senator **Graham**. The question I asked was what will be the effect of these new basal capital risk standards on new lending to Latin America.

Mr. **Mulford**. Well, I think they probably over time, depending on the condition of each bank, will be somewhat restrictive.

Senator **Graham**. Somewhat restrictive?

Mr. **Mulford**. Yes.

Senator **Graham**. Why? I mean that is a much more optimistic definition of the banks' attitude than I have seen and heard elsewhere. Why do you think it will only be somewhat restrictive?

Mr. **Mulford**. But what I said was banks have different positions and so on, so I used the words "somewhat restrictive" in the general sense. It may be very restrictive for certain banks, less so for others.

Senator **Graham**. Whenever you want to ask a question, Mr. Chairman, I am sort of moving from topic to topic here.

Senator **Sarbanes**. Secretary Mulford, I want just to make a couple of comments and get your response.

I think it's very important that this issue be put in a broad context in trying to justify this new departure in response to some of the points that might be made to you by Members of Congress or others.

First of all, it is very clear to me that if we do not help Mexico address its economic problems, we are going to have a marked upsurge in the illegal immigration problem, are we not, on our southern border? Would you not assume that almost as a given?

Mr. **Mulford**. Well, I certainly agree that Mexico is important and if its problems are not addressed, there will be a variety of problems that will face the United States.

Senator **Sarbanes**. Second, is it not very clear that the inability, particularly of Latin America, which was always a sort of a natural market for the United States for its exports, the inability of those countries to be on a growth path has had a significant negative impact on our own economy because it means that our exporters have, in effect, been shut out or at least have significantly lost position in a contracting market?

Mr. **Mulford**. That is correct. It is a very important point, that if this produces a measure of success with countries we really will see a situation in which growth will be stronger, resources will be more plentiful in those countries, and the United States will more quickly regain important export markets.

Senator **Sarbanes**. Some important economic benefits that flow, not just economic costs, with this approach, there may be some economic costs associated, and you are trying to minimize those, but it ought also to be recognized that in that balance are potentially very important economic benefits.

Mr. **Mulford**. Correct.

Senator **Sarbanes**. Second, I think there are very important political benefits. I am frank to tell you that I do not think that Secretary Baker will be able to have a U.S. foreign policy, a positive, constructive foreign policy, in some areas of the world if it doesn't have a debt dimension to it.

I mean as soon as he goes to those countries to talk about other issues, their immediate reaction in terms of anything that involves cooperation is, "Well, let's talk about the debt question."

In fact, I think the administration has encountered that, and the leaders there have certainly made that clear to President-elect Bush and then President Bush and, I think, to some extent impacted on the President's thinking.

Mr. **Mulford**. Well, I think that's right. Secretary Baker has been very supportive of this approach.

Senator **Sarbanes**. Well, I am very pleased to hear that.

Let me ask this question. Where does the Brady plan now stand within the administration? Are there differences within the administration about it—or the Brady, let me say?

Mr. **Mulford**. The Brady proposal, as you refer to it, has the full support of the administration, including the President, who issued a statement several days ago supporting fully the concepts and processes involved in debt reduction and establishing stronger growth in the debtor countries.

Senator **Sarbanes**. All right.

Now, I think those concepts and processes to represent a significant breakthrough. I said that at the outset. I have not wanted this morning to press you on some matters because I think you have to work it out; in other words, how much money are you talking about, which is of course very significant. But at least what has happened.

My perception of the problem was that you had people in the debtor countries in effect dying of thirst. And Donald Regan said to them, "Don't be thirsty."

Secretary Baker put a glass in front of them, and he thought he would be able to get water into the glass, and it didn't work. I mean at least he wanted to get on to growth, but it didn't happen.

And I think now you have come with a glass and with a concept that will put some water in it. Now the question is how much water and whether you put enough to address the thirst. I think that is the question.

Now, as you have pointed out, it is very complicated. Obviously, if you do not get enough of a bank contribution at the outset and the balance of the burden is in some way collateralized internationally, you still have not worked out from under the problem.

You have to have enough of a dent in the debt overhang and the debt service that the countries can realistically get on a proper growth path and institute the right reform measures. And that is, I think, a very critical matter which has to be very carefully worked out.

You obviously need a large enough discount so that there is a sizable amount of debt reduction adequate so the country realistically can be back on a growth path. If you do only some of it and they still have the debt overhang you are not going to get the positive results and yet you will have the costs associated with what little bit you have done.

Therefore, I think it is very important that you get enough water in that glass to slake the thirst and enable these countries to start growing.

Finally, I just want to underscore the urgency of it. I think you appreciate that. You tend not to be the kind of witness who dramatizes it, but I think—at least I hope ——

that you fully understand it.

Bill Rogers, last Friday, described the mood in Latin America as one of desperation. And then he warned that, you know, if you raise expectations, you have to satisfy them to some degree, otherwise desperation mixed with expectation is a volatile brew.

That is happening now. I mean the Chileans apparently—at least there is one report talking about a moratorium on debt service if the fruit import question is not resolved and so forth.

So, this thing, in the political arena, it has a rolling dimension of its own, and we are seeing that now. You have these elections coming up, the possibility of people winning who would be less likely to take some of the measures that most everyone thinks are necessary to do it.

So, we obviously intend to stay close with this issue, monitor it. We want to work closely with you. I do think that you have got concepts out now on the table which, if properly done in terms of magnitude and timing, could result in a major shift in the dimensions of this problem.

But that is the critical question, the critical question of is there enough water in the glass. And I just urge you, in trying to resolve that question, to think with a larger rather than a smaller concept, and particularly to take into account all of these other matters which are important to our national interest and may themselves involve very significant costs in any event if they should eventuate: immigration, the expansion of trade, the basis for political cooperation with many of these countries that may solve other pressing issues which the United States confronts.

The president of Venezuela, in his inaugural, talked in the same paragraph about these shared problems: debt, Panama, and Central America. And obviously, if we could resolve some of those problems with their help, it is of enormous importance to our political and security interests, and we would end up probably saving a lot of money.

So, I would simply close by sort of urging you on and with a strong sense of the pressing nature of this problem. I think it needs to be addressed sooner rather than later. I think you are on a timetable where, in effect, the IMF meetings and the G–7 discussions, as I perceive them, constitute the outside parameters for really putting something into place and it's got to be something that is sufficiently adequate that people can look at it and say this has a real chance of working.

There is no way you can guarantee it, but at least the dimensions of it, as one examines it, must be such that, making reasonable assumptions, it has a realistic chance of working. Then you can get everyone's attention turned to the real problems which are the underlying issues, instead of constantly going through one crisis after another on the rescheduling of the debt, the potential defaults, the moratoriums, the suspensions, and so forth.

I appreciate your being here with us this morning very much. We look forward to additional sessions.

Mr. **MULFORD**. Thank you.

Senator **SARBANES**. Senator Graham?

Senator **GRAHAM**. Thank you Mr. Chairman.

I have some other questions which I will submit in written form. But I would, in the strongest terms, echo what the chairman has just said. This is not just a commercial issue. This is a fundamental issue of America's future.

I happen to represent a State which has seen a staggering increase in refugees from countries which have not only been beset by military activities but also by significant economic decline.

I represent a State which has seen a significant loss of jobs because of the decline of our trade with Latin America, and a State which, unfortunately, has been the principal point of importation of drugs, a commodity which has been increasing in its international trade, in large part because other activities are not available in producing countries.

So, this is an issue which is not an arcane international economic subject, but at the heart of many of our most fundamental problems.

Down the hill from here is the Union Station. That building was designed by a great Chicago architect, Daniel Burnham. Burnham lived by the dictum that said, "Think no small ideas. Small ideas have no magic to stir men's minds."

I am concerned, Mr. Mulford, that we have been bombarded with a series of small ideas as to how to deal with this problem.

I in candor am much depressed this morning because I had hoped that we would hear a concept that had a breadth of vision to deal with this issue, a sense of the opportunities that were on the other side of solving this issue.

To use the chairman's example, I am afraid that in terms of the glass of water, that we have been given another rock and are going to be asked if we can squeeze water out of this.

I frankly believe in monitoring performance by numbers, and I am going to be looking at some numbers, some of which you have suggested as being what you think the report card ought to be, some of which I am going to add to the list, to see if we make some real progress, because we cannot afford to sit around for 5 years as we did with the Baker plan hoping that things are going to get better, and see them disintegrate to the point that they have today.

I am fearful that the rock that we have been given is not going to yield water but is going to yield a deepening of the economic and political collapse of Latin America for which this country, not only in the 1980's and 1990's but well beyond, will pay a very, very serious price.

I would encourage you to return to the Treasury by taking the Metro from Union Station and look at that beautiful building and see if it won't inspire some ideas that will have magic to move men's minds and toward a solution to this fundamental American issue.

Mr. **Mulford**. I looked at that in Union Station 4 months ago, Senator, and I have been working along those lines ever since. And with respect, I hope you will withhold your judgment until you do know exactly what the resources are that are involved and so on, because we have not really covered that point this morning.

Senator **Graham**. I am going to hold my judgment. It is going to be based on performance. The process days, from my standpoint, are over.

But we now need to see some substantial change in performance, and it is only that change that is going to have meaning in terms of resolving issues in our neighboring countries and beginning to moderate the adverse consequences of economics, drugs, refugees, that we are suffering from this continued malaise of ideas.

Senator **Sarbanes**. The subcommittee stands adjourned.

We appreciate your appearance and testimony.

Mr. **Mulford**. Thank you.

[Whereupon, at 10:55 a.m., the subcommittee was adjourned.]

[Additional material and responses to written questions for the record follow:]

POLICY ANALYSES IN INTERNATIONAL ECONOMICS 25

VOLUNTARY APPROACHES TO DEBT RELIEF

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Voluntary Approaches to Debt Relief

1 *Introduction*

It is now six years since the debt crisis erupted with Mexico's declaration of a temporary moratorium on interest payments in August 1982. Earlier hopes that voluntary access to capital markets could be restored relatively quickly have been disappointed. No end to the crisis is in sight.

The vulnerability of the major private banks to Third World debt has been substantially reduced since 1982. Unfortunately, the situation of the debtor countries has not shown a comparable improvement. The proportion of export earnings needed to pay interest did fall when interest rates declined from the extraordinarily high levels of the early 1980s, but the ratios of debt to exports and GNP have continued to rise (although this may partly be attributable to previous underrecording of debt). The real resource transfer remains strongly negative, around $30 billion a year in 1986–87,[1] diverting savings from the investment needed to restore growth to satisfactory levels. While per capita income growth has returned to positive levels, it has not yet in general reached the rate of growth of productive potential, let alone started to make up the ground lost in the early 1980s.

In this situation, it is not surprising that proposals for reducing debt burdens continue to be advanced and even, in modest ways, implemented. Proposals for debt relief—defined as a mutually agreed reduction in the present value of future debt service obligations[2]—lie on a spectrum between those that are

mandatory and comprehensive and those that are voluntary and case-by-case. This study deals with proposals at the latter end of the spectrum, and focuses on debt held by the commercial banks.

Section 2 of this study briefly reviews the problems of more comprehensive approaches to debt relief. The analysis of "voluntary" approaches, meaning those in which each bank has the option of deciding whether or not to grant debt relief, as defined above, starts in section 3. This section is devoted to identifying the sources of potential gain from voluntary debt relief: these consist of positive incentive effects for debtor countries (summarized in the notion of a "debt relief Laffer curve") and the divergent interests of different banks. Most bankers seem to take the latter for granted, while many economists neglect or deny these divergences, so much of the argument in this section is directed at my fellow economists. Readers who accept the conclusion can skip this relatively technical section without losing the thread of the argument.

Section 4 examines alternative mechanisms for the provision of voluntary debt relief: buybacks, exit bonds, and debt/equity swaps. It compares buybacks and collateralized exit bonds and argues that the latter have little if any advantage over the former. It also discusses the forms and conditions under which uncollateralized exit bonds might be feasible, concluding that either guarantees or credible seniority would be essential. Debt/equity swaps can be useful under certain circumstances, although those circumstances would cease to exist if the remainder of the proposals developed in this study were adopted.

Section 5 deals with the design of a program of voluntary debt relief. It asks why, if section 3 is correct in arguing that there exists a strong common interest in the provision of voluntary debt relief, so little has happened until very recently. It suggests that the reasons that explain past inaction need not preclude future initiatives. Buybacks can be facilitated relatively easily, although it will be necessary for the banks to acquiesce in the provision of financial resources and grant waivers of certain traditional clauses in loan contracts. Exit bonds would require greater institutional change, since a substantial program will almost certainly require the provision of World Bank guarantees. This section also discusses the possibility of a definitive restruc-

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[1] This figure relates to all developing countries (and comes from the latest edition of the *World Debt Tables* (1988, Table 1). The comparable figures for the World Bank's 17 "highly indebted countries" that provide the primary focus of this study were $25 billion in 1986 and $20 billion in 1987 (*World Debt Tables* 1988, Table 2). The 17 highly indebted countries are Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

[2] The term "debt relief" is sometimes used (especially by the IMF) in a looser sense that encompasses debt rescheduling. This is unfortunate, because there is then no obvious term that makes the important distinction between debt reconstructions that reduce the present value of debt-service obligations and those that do not. (A possible candidate would be "forgiveness," but this has connotations of free choice on the part of the creditors. It would seem odd to say that those banks that participated in the Bolivian buyback forgave 89 percent of their holdings of Bolivian debt.)

turing of the banks' loans, providing for automatic capitalization of interest charges above a level related to export performance, in order to supplement voluntary debt relief should the need arise.

The final section of the study tries to provide some estimate of the impact the initiatives discussed in section 5 would have on the debt problem. It concludes that buybacks alone, though helpful, could leave debtor countries under quite severe financial constraints for several years, unless, of course, improved export performance comes to the rescue. An extensive program of exit bonds has more potential, but major relief would again be delayed. Hence it may well prove desirable to supplement voluntary debt relief with a major debt reconstruction, at least for some countries, for those banks that choose not to exit.

2 *Comprehensive Schemes for Debt Relief*

It may be useful to preface a critique of schemes for comprehensive debt relief with some semantic distinctions among comprehensive, mandatory, voluntary, case-by-case, and market-oriented proposals, since all of these terms are used to describe and contrast alternative approaches.

A truly comprehensive scheme would presumably treat all loans by all creditors to all debtors in the same way. Even after one restricts "all creditors" to commercial banks and "all debtors" to the public and publicly-guaranteed (or "sovereign") debt of developing countries, it is not clear that anyone has advocated a truly comprehensive scheme. Most proposals are restricted to troubled sovereign debtors. A noncomprehensive approach on the debtor side is generally described as "case-by-case," which really means country-by-country.

A comprehensive approach on the creditor side means that all lenders to a particular debtor have their debt restructured on similar terms. Most debt restructurings to date have been comprehensive in this sense, but they have avoided granting debt relief. It is much more difficult to imagine the banks agreeing voluntarily to a comprehensive scheme that provides debt relief, which is why some schemes that aim at comprehensive relief are mandatory, meaning that they seek to compel all creditors to grant equal debt relief. However, many schemes that aim at comprehensive coverage of creditors shy away from being explicitly mandatory, and seek instead to persuade all

banks to participate by weighing the scales in favor of making that choice (for example, through regulatory requirements).

The opposite of a mandatory approach is a voluntary one, in which each bank decides for itself whether to grant debt relief. The hallmark of a voluntary scheme is that different banks are expected to make different choices. In practice, voluntary schemes are virtually bound to be market-oriented, since the market establishes a price at which some potential sellers will choose to sell and others will choose not to.

Although the opposite of voluntary schemes are mandatory rather than comprehensive ones, the practical choice has been between schemes that aim to be comprehensive (even if they seek to avoid being explicitly mandatory) and those that are voluntary and aim to exploit the different interests of different banks. It is thus appropriate to contrast voluntary with "comprehensive" approaches such as those of Kenen (1983) and Rohatyn (1983), more recently Robinson (1988) and Sengupta (1988), and the congressional initiatives of LaFalce (1987) and Pease (1988).

A typical version of a comprehensive scheme proposes the creation or designation of some international agency charged with buying sovereign debt from the banks at a discount from face value in exchange for an issue of its own obligations. The agency would then lower the interest charged to the debtors (and/or extend maturities), and use the income it received from the debtors to pay the banks (while adding its guarantee that the lower level of earnings will in fact be paid). Proposals have differed enormously with respect to country coverage, the extent and variation of concessionality, mechanisms to induce participation, and so on, but the stylized proposal presented here helps to identify the critical problems inherent in a comprehensive scheme.

One problem is *inducing the banks to participate*. If the scheme provides sufficient debt relief to enable the debtor to handle its debt comfortably, then the debtor will be in a position to service in full the claims of any fringe of uncooperative banks that stand aside from the scheme. Any bank too small to believe that its individual nonparticipation will jeopardize the scheme has an incentive to act as a free rider, but the collective nonparticipation of numerous small banks could jeopardize the scheme's viability. This is the familiar free-rider problem. It is not in fact clear, however, that the principal reluctance to participate would come from the small banks: many large banks have adamantly proclaimed their unwillingness to sell at any substantial

discount, in the expectation that debtor countries will ultimately recover.[3] Hence the need either to make participation mandatory or to penalize nonparticipants if reasonably comprehensive coverage of creditors is to be achieved at a price that confers a worthwhile degree of debt relief.

Legislation to compel banks to participate would seem problematical even in one country, let alone in all of the dozen or so major creditors. It is easier to imagine the penalization of nonparticipants through regulatory requirements (for example, requiring nonparticipating banks to write their loans down immediately to the value at which they would have sold them to the agency, while permitting sellers a gradual write-down).[4] The debtor might be able to help the process by treating debt bought by the agency as senior. To the extent that government authorities hesitate to employ these mechanisms with sufficient force, banks would have to be bribed to participate by use of the public purse.

A second problem is determining *how to govern country access to the debt relief facility*. This has two dimensions: how to decide which countries are covered, and how to decide the price at which the agency should buy the debt of participating countries. One surely could not limit access to the 15 countries on the Baker list, or the 17 classified as highly indebted; many other countries in equal distress have small amounts of commercial bank debt that they would certainly wish to trade in if they had the opportunity. Moreover, the availability of substantial debt relief would change the incentives facing countries (like Indonesia) that have worked hard to avoid rescheduling up to now. Popular pressure might make it difficult for the authorities of countries that do not need debt relief to resist the temptation to avail themselves of it.

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[3] This view is, incidentally, fully supported by the most cogent modeling available. See, in particular, Daniel Cohen (1985).

[4] A conceivable alternative would be to have the IMF use its legal authority (under Article VIII, Section 2) to approve exchange controls. By making an authoritative interpretation that the disputed phrase "exchange contracts" includes international debts (an interpretation in the past rejected by US and British courts, but in which a Fund interpretation would override national interpretations), the Fund could give itself the right to approve the suspension or limitation of interest payments to banks located in the creditor countries. It is unclear how far this would take one, however, since legal opinions differ on whether interruptions of debt-service payments by the state (or state agencies) could be authorized in this way.

The problem of deciding the price at which such an agency should buy up the debt is also difficult. It is clear that debt could not be bought at a uniform price: the extent of relief needed in Bolivia or the Sudan would—despite the much lower level of bank exposure than in 1982—still threaten to bankrupt major banks in the United States, Great Britain, and Canada if extended to all the major debtors. Prices quoted on the secondary market might be taken as a guide, although the choice of a base date would then become a sensitive issue.

The use of secondary market prices would also raise the issue of equity: the debt of a country that has conscientiously tried to service its debts commands a higher price than that of a country that has declared interest moratoria or otherwise undermined confidence that it would strive to maintain debt service.[5] If current rather than past prices were used, an acute problem of moral hazard would arise. Requiring the banks to sell out at a price close to that quoted on the secondary market would also pose an equity issue to them. After all, insofar as the price in such a thin market measures anything, it measures the price at which they could have sold in the past, but chose not to. On the other hand, countries might resist retaining a debt substantially greater than that implied by the secondary market price, especially if they perceived their own terms to be more onerous than those of their peers. The managers of the responsible agency would, in short, have a difficult task in selecting swap prices.

Both of the preceding problems could be ameliorated by *the provision of public funds*, either in the form of cash or guarantees. Most schemes in fact call for the debt relief agency to guarantee the payment of the reduced level of debt service, which implies a guarantee for a very substantial sum, running into tens of billions of dollars each year. Many also propose a direct injection of cash.

If public funds were available for such purposes, one has to wonder whether it would be proper that they be directed to aiding the countries that overborrowed in the past, rather than to the unfortunate group of countries that were too poor ever to have been creditworthy enough to borrow. But one has to wonder even more what reason there is for supposing that public money might conceivably be made available on the requisite scale. However

much one may regret it, a "Marshall Plan" for Latin America or any other region does not look like practical politics. The proposals made later in this paper, which would make bold though temporary use of the financial leeway provided by the World Bank's recent general capital increase to guarantee exit bonds, assume as much as it now seems realistic to ask the Western body politic to sanction. Drawing up plans that require even greater commitments of public funds seems unlikely to be constructive.

Admittedly, schemes for official action to force debt relief on the banks need not in principle require an input of public money. One alternative would be to establish an international tribunal empowered to organize an equivalent to "Chapter XI" proceedings for troubled sovereign debtors. I have suggested such an approach myself in the past (Williamson 1985), and Cohen (1988) has recently pursued the same line of thought. But this approach would involve a major act of institution-building, and perhaps legislation, and it is therefore out of the question unless the debt question is given a much higher political priority by Western leaders.

A final problem with negotiating a comprehensive debt relief scheme is that of *moral hazard*. This refers to the possibility that a party will be induced to modify its actions in a way that prejudices overall efficiency. In particular, if countries can qualify for significant debt relief by building up a debt burden that they cannot service or by eroding their capacity to service debt, this creates an incentive to act precisely in that way. Most schemes for debt relief seek to prevent such a response by basing the entitlement to debt relief on the circumstances existing on some date before the scheme was announced, and/or by imposing conditionality as a *quid pro quo*. But it is not clear that such solutions are totally adequate: it is doubtful that it would be possible to exclude from access to the facility a country that encountered a debt problem subsequent to the facility's establishment unless there was unambiguous evidence that the country had deliberately provoked its problem.

Moral hazard is not just a problem that affects the debtors. Creditors may also have an incentive to block solutions that recognize that the debt servicing capacity of the debtors has eroded, in the hope that they will be able to induce an input of public money. Perhaps this helps explain the banks' limited enthusiasm for innovative approaches to debt reconstruction, as well as their repeated calls for governments to play a larger role in the debt crisis. One cost of the continuing hankering after "comprehensive" solutions is that it discourages the banks from accepting the types of initiatives explored in this study.

Doubtless none of these problems would prove insuperable if there developed a strong political will either to resolve the debt crisis quickly or to protect the global financial system against an acute worsening of the debt problem precipitated by a severe world recession. The problems are nonetheless sufficiently formidable to provide ample justification for an exploration of the potential of the alternative—voluntary—approach.

3 The Logic of Voluntary Debt Relief

Unlike proposals for comprehensive debt relief, none of which have yet left the drawing board, several instances of voluntary debt relief have already occurred. The first mechanism used for this purpose was the debt/equity swap, which has been implemented in a number of countries, including Argentina, Brazil, Costa Rica, Mexico, the Philippines, and, most extensively, in Chile. In a debt/equity swap, a potential investor buys the country's debt on the secondary market and then trades it in at the central bank for local currency to use in equity investment (usually with some restrictions on remittance rights). To the extent that the central bank buys back the debt at less than 100 cents on the dollar, the country obtains a measure of debt relief.

From the standpoint of the debtor country, one unattractive feature of debt/equity swaps is that much of the benefit of the secondary-market discount goes to foreign investors rather than to itself. This is avoided with another instrument for voluntary debt relief, the buyback. Buybacks contributed significantly to the cleaning up of Latin America's debt problems in the 1930s (Eichengreen and Portes 1988; Jorgensen and Sachs 1988). At the time, one of the proponents of buybacks was a promising young economist named Henry Wallich (1943). Until recently, however, their potential relevance in helping resolve the present debt crisis has been almost entirely overlooked. The first extensive discussion can be found in Portes (1987). A substantial volume of private Mexican debt is believed to have been bought back over several years, but the first actual buyback of sovereign debt (so far as is known) was made by Bolivia in March 1988.

With the approval of the International Monetary Fund (IMF), Bolivia bought back some 47 percent of its commercial bank debt at a price of 11 cents on the dollar, using funds specially donated for this purpose by friendly governments. It was emphasized that this did not constitute a precedent. And

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[5] The econometric estimates of Sachs and Huizinga (1987, 563) suggest that interest suspension depresses the secondary market price by about 17 cents on the dollar.

Bolivia is indeed a very special case. It is the second-poorest country in the Western Hemisphere and has the highest debt/export ratio. It has undertaken the most sweeping liberalization of a previously over-regulated economy, halted a hyperinflation, and suffered a collapse in the price of its principal legitimate export (tin), all while still combating the drug trade and restoring democracy. All actions create precedents, whatever declarations to the contrary are made, but Bolivia's situation was so special that the precedent was surely minimal.

The same can hardly be said of Mexico. Yet the US Treasury endorsed Mexico's plan for swapping debt into bonds whose principal is collateralized by zero-coupon US Treasury securities. Even though bankers did not bid for those bonds on a large scale on terms that the Mexicans found acceptable (and the analysis in the appendix suggests that this was to be expected), the blessing of the proposal by the US Treasury has altered the parameters of the debt crisis. Debt relief is no longer a taboo subject: the questions are whether, under what circumstances, and how it should be legitimized.

The case for legitimizing debt relief rests on two propositions. The first is that debtors are unable to fulfill their contractual obligations and therefore need cash-flow assistance either in the form of debt relief—a scaling down of those obligations—or "liquidity relief"—a postponement of a part of those obligations (which can be accomplished by the provision of "new money," among other things). The second is that banks have very different preferences with respect to the form of relief they provide, and that even those that prefer to provide liquidity relief can expect to benefit if the desires of those that would prefer to provide debt relief are accommodated. These two assertions are elaborated below.

THE NEED FOR CASH-FLOW RELIEF

So long as a country has voluntary access to the international capital market or holds more than minimal working balances in the form of international reserves, it is in a position to meet its contractual debt-service obligations irrespective of its trade balance, either by increasing its foreign liabilities or by drawing on its foreign assets. Conversely, once a country has lost voluntary access to the international capital market and drawn down its excess reserves—which has by and large been the situation of the highly indebted countries since 1982—its ability to service debt is constrained by the trade surplus it

can generate. Strictly speaking, the constraint is provided by the balance on goods, services, and transfers, plus any net inflow of direct and official investment, minus the service of any senior debt (for example, to multilateral development banks [MDBs]). This may be referred to as "the surplus available for debt service," or, more briefly, the "surplus."

The following analysis requires some assumptions about the future path of this surplus, and also of the debt-service obligations. The procedure adopted here will be to start with simple but unrealistic assumptions whose implications are easy to see, and then relax these assumptions to recognize progressively more complex, but realistic, situations.

The simplest possible assumptions are that both the surplus and the debt-service obligations are fixed at some known exogenous level and are constant over all future time. In this case the country is solvent and can pay all its creditors in full if and only if the surplus exceeds the contractual debt-service obligations.[6] In the converse case, it is insolvent and some or all creditors must necessarily receive less than their contractual entitlement. Debt relief is inevitable and liquidity relief is pointless; postponement of obligations is simply a denial of the reality that the country cannot afford to pay what it owes.

Suppose one retains the assumption that debt-service obligations are fixed at some known, exogenous, and constant level (an assumption that is approximately true when debt is repeatedly rescheduled but no new money is available), but modifies the assumption concerning the surplus available for debt service. Specifically, suppose that the surplus is known and exogenous but may vary over time. Whether the country is solvent or insolvent is again well-determined (provided, at least, that the interest rate faced by the country is also known and exogenous). If the surplus grows faster than the rate of interest, then we have the case of the solvent but illiquid debtor that can service its debt provided that it gets liquidity relief.[7] Debt relief would provide

a perfectly acceptable form of cash-flow relief from the debtor's standpoint, although it would obviously be less advantageous to the creditors.

Paul Krugman (1988a) has raised the question of why such a country should ever be illiquid: if it will ultimately be able to service its debt, it should have no difficulty in borrowing to tide it over the interim period. The answer is that two of the assumptions adopted up to this point are unrealistic—the assumptions that the path of the surplus is known with certainty and that it is exogenous.

Consider first the case of uncertainty, but simplify again by assuming that the probability distribution of the surplus is constant over time. If the mean μ of this probability distribution is less than the debt-service obligation (B_1 in figure 1a, for example), then the country is insolvent and debt relief will be needed sooner or later. If the mean exceeds the debt-service obligation (B_2 in figure 1b), but the actual outcome is less in a period when the country has no reserves, the debtor is solvent but illiquid. Liquidity relief would enable it ultimately to service its debt in full. If the bankers knew for certain that the country was solvent, they would again have no reason to deny the debtor new loans to tide it over. But this is not known with certainty. So long as there is a positive probability that the debtor is solvent, it is in the *collective* interest of the banks to provide liquidity relief rather than debt relief. However, it is in the *individual* interest of each creditor that the liquidity relief be provided by *other* creditors, so as to avoid inadvertently providing debt relief if it turns out that the creditor is really not solvent after all. Hence the free-rider problem.

In reality, the probability distribution of the surplus is not only uncertain but changes over time. In particular, views may differ on the likelihood that the probability distribution will tend to move to the right over time and, if so, whether it will move to the right faster or slower than debt service is growing as a result of interest compounding. Clearly this conjunction of circumstances provides ample scope for the situation in which it is in the collective interest of the banks to provide liquidity relief, and thus maintain the option of ultimate full recovery of their claims if circumstances turn out to be favorable, but in which this outcome is sufficiently uncertain to give each bank (and especially those with more pessimistic expectations) a strong incentive to liquidate its exposure if this is possible without undue loss.

The final assumption that needs to be relaxed is that the surplus available for debt service is exogenous with respect to the country's own actions. Clearly this assumption is useful only as an intermediate analytical tool: if it

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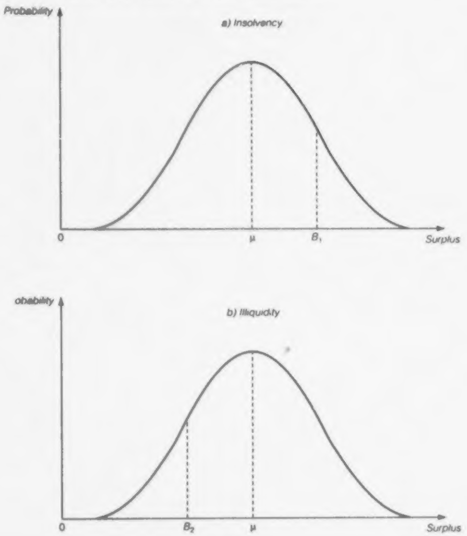
[6] Let S_t be the surplus available for debt service in year t and B_t be the debt service obligation due in year t. The condition for solvency is $\int_0^\infty S_t e^{-it} dt > \int_0^\infty B_t e^{-it} dt$, where i is the interest rate. For $S_t = S$ for all t, $B_t = B$ for all t, this degenerates to $S > B$.

[7] In terms of the inequality in footnote 6, a constant level of B_t guarantees that the right-hand side is finite, while S_t growing faster than i implies that the left-hand side is infinite. (This is an overly strong condition for solvency, but one that is familiar from the debt literature.)

FIGURE 1 **Frequency distribution of expected surplus**



were literally true, it would imply that a debtor country was unable to benefit from debt relief by increasing its imports!

In fact, there is rarely, if ever, any relevant absolute limit on a sovereign debtor's ability to service debt. The relevant limit is set by the sacrifices that

it is ethically tolerable or politically wise to impose on the populace.[8] Just how great a sacrifice should be imposed at any time is a subject on which the views of creditors and debtors can be expected to differ. The desire of creditors to ensure that their interests are not neglected tends to lead to the "short-leash approach," a preference for repeated reschedulings rather than definitive debt reconstruction, and tight conditionality. Recognition of the endogenous nature of the size of the surplus does not, however, mean that situations do not arise in which creditors have to provide either debt relief or liquidity relief. It simply means that the total amount of cash-flow relief that is needed will to some extent be a subjective variable about which creditors and debtors will typically have differing views.

It is not necessarily true that creditors have an interest in minimizing the debtors' cash-flow relief. The Baker Plan is based on the recognition that inadequate cash flow can thwart a debtor country's ability to adjust by growing out of its difficulties. Creditors have a collective interest in making this possible by the provision of liquidity relief, even though each individual creditor might prefer to reduce its exposure.

It can be argued, however, that simply affording a country the *opportunity* of adjustment-with-growth by providing it with an adequate cash flow to invest in export-generating projects may not suffice to ensure that it will actually exploit those opportunities. A major purpose of conditionality is to help ensure that debtors provided with additional foreign exchange do indeed use it for appropriate investments rather than for increased consumption. But conditionality should not be expected to persuade a country to act in a manner contrary to what it perceives as its national interest. The constructive role of conditionality is to provide financial muscle to that group of a country's decisionmakers that is urging that policy be based on what is good for the country in the long haul rather than what is politically easy in the short run. The precondition for conditionality to be able to secure an appropriate growth-oriented strategy is therefore that such a strategy actually be in the long-term interest of the country. It has been argued that this need not always be true, because of disincentive effects. Where these are sufficiently powerful, creditors and debtors may share a common interest in debt relief.

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[8] A more extreme view than that suggested here is adopted by Eaton, Gersovitz, and Stiglitz (1986, 485), who deny the importance of capacity to pay in constraining debt service ("[in] international loans . . . the resources of the debtor are likely to be adequate to repay the loans regardless") and conclude that willingness to pay—the "enforcement problem"—is central.

THE DEBT RELIEF LAFFER CURVE

Such an argument was raised by Bergsten, Cline, and Williamson (1985, 169), in criticism of the proposal that debt-service payments should be limited to a specified proportion of exports. The authors pointed out that this would constitute "a disincentive to export expansion, operating like an export tax." The disincentive effect of this formula would be larger if the excess of contractual obligations over the payments implied by the formula were to be forgiven rather than capitalized.

It has been claimed subsequently by Sachs (1986, 1988) and Krugman (1988a, 1988b) that a similar, but more powerful, disincentive effect can arise from the existence of an unmanageably large external debt.[9] An admirable summary of the argument is provided by Krugman:

> When a country's obligations exceed the amount it is likely to be able to pay, these obligations act like a high marginal tax rate on the country: if it succeeds in doing better than expected, the main benefits will accrue, not to the country, but to its creditors. This fact discourages the country from doing well at two levels. First, the government of a country will be less likely to be willing to take painful or politically unpalatable measures to improve economic performance if the benefits are likely to go to foreign creditors in any case. Second, the burden of the national debt will fall on domestic residents through taxation, and importantly through taxation of capital; so the overhang of debt acts as a deterrent to investment.
>
> Over and above these costs to potential repayment is the fact that no clean Chapter XI proceeding exists for sovereign debtors, and a confrontational and disorderly default may reduce the actual receipts to a creditor below what could have been obtained if debt had earlier been reduced to a level that could have been paid.
>
> The upshot of these negative effects is that the higher is the external debt of a country, the larger the probability of nonpayment; and thus the greater the subjective discount on that debt. If debt is high enough, further increases in the level of debt may actually lead to a *smaller* expected value of payments (1988b, 9–10).

Krugman illustrates the relationship between the level of debt and a creditor's expectations in terms of a diagram, reproduced in figure 2. The

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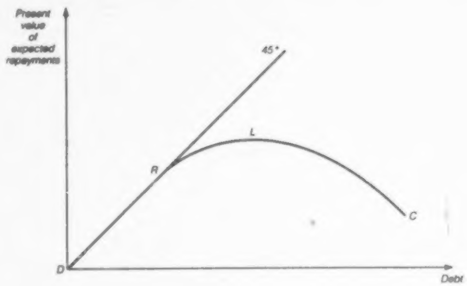
[9] See also the formalization of Corden (1988). In addition, Cohen (1988) has explored a different rationale that leads to the same conclusion. He argues that the present creditor strategy, which he characterizes as a hard-nosed attempt to extract full contractual debt service, risks provoking the debtors into a confrontation from which both will lose. He concludes that enlightened creditor self-interest demands partial debt forgiveness to preempt this danger.

FIGURE 2 The debt relief Laffer curve



horizontal axis shows the level of debt and the vertical axis shows the expected present value of repayments. For low levels of debt from *D* to *R*, full repayment is expected, and so the outcome lies along the 45° line. At higher levels of debt, however, the possibility of nonpayment arises and grows, so that the expected payment line traces out a curve that falls increasingly below the 45° line. Beyond some point (*L*), the disincentive effects outlined above begin to outweigh the option value to the creditors of being able to share in the debtor's good fortune, should outcomes prove unexpectedly favorable. Krugman explains:

> The curve DRLC should by now be a familiar sort of object. It is the *Debt Relief Laffer Curve*. That is, just as governments may sometimes actually increase tax revenue by reducing tax rates, creditors may sometimes increase expected payment by forgiving part of a country's debt. In both cases the proposition that less is more depends on an initial extreme situation, whether of taxes that provide extreme disincentives or of a debt burden that is crippling in its effect on economic growth. Arguments that debt relief is in everyone's interest are, in effect, arguments that countries are on the wrong side of the debt relief Laffer curve (1988b, 11–12).

Two qualifications to this argument must be acknowledged. First, except under the most extreme circumstances (perhaps those of the Sudan rather than of any major Latin American debtors), countries will place some value on the reduction in their external debt that will result from enhanced export revenue. It is not *just* increased import capacity that policymakers value. Second, even if they do value additional import capacity more highly than an equivalent reduction in debt, increased export revenue will not normally be taxed away at 100 percent. Indeed, until the next new money package is negotiated, the implicit tax rate is zero. With multiyear new money arrangements there can thus be a substantial period during which all additional export revenue is available to the country.

Nonetheless, the fact remains that new money packages have to be based on an estimate of the financing gap, and it is virtually unavoidable that past success in increasing exports will be translated into a lower estimate of the future financing gap. (The position is even more clear where new money is given to clear past arrears.) This implies a high marginal "tax rate" on increased exports in the long run, almost inevitably a much higher rate than that implicit in a link between debt-service payments and export revenues. This is bad supply-side economics.

Ize and Ortiz (1987) have pointed out that a similar result may occur through a different channel. One factor that impedes the repatriation of flight capital is the fear of domestic wealth owners that an excessive level of external debt may force their government to take measures that jeopardize the value of local assets (for example, high taxation, inflation, or even expropriation). A measure of formal debt relief might ease these fears and thus improve the prospects that capital would return, which would in turn facilitate continued payment of the lower contractual level of debt-service payments.

Hence one reason that debt relief may benefit creditors is that it may improve the incentive structure facing the debtors. But this is not the only reason.

DIFFERING BANK PREFERENCES

The other reason is that the preferences of banks may differ. Some may prefer to liquidate their exposure or make it less risky, even at the cost of a substantial reduction in the present value of their contractual entitlements. Others may prefer to maintain the present value of their claims and provide liquidity relief instead of debt relief. Both groups may gain *ex ante*, according to their own preferences, if the former group is accommodated.

This proposition may be demonstrated with an arithmetical example, which is a modified version of that presented in Krugman (1988b, 14–17).[10] Consider a country that has foreign exchange reserves of 10 and debt service of 100 due in the next period. Suppose that it faces two possible outcomes, a "bad" state in which it will generate a foreign-exchange surplus available for debt service of 20, and a "good" state in which the surplus will be 80. Suppose also that 20 percent of the debt is held by "pessimists," who attach a probability of 2/3 to the bad outcome and 1/3 to the good outcome, while the remaining 80 percent is held by "optimists," who believe that the probability of the bad outcome is only 1/3 and that of the good outcome is 2/3.

If there is no buyback, the country will have available for debt service 30 in the bad state (the surplus of 20 plus the initial reserves of 10) and 90 in the good state (80 plus 10). Assuming risk neutrality, the pessimists will value this debt service at $2/3\ (30) + 1/3\ (90) = 50$, while the optimists will value it at $1/3\ (30) + 2/3\ (90) = 70$.

Suppose instead that the country uses its reserves of 10 to buy back the 20 of debt held by the pessimists at the price of 50 at which they value it (plus epsilon, to persuade them to sell and ensure that they too are better off after the buyback). Then in the bad case the remaining creditors will get 20, while in the good case they will get 80 (full debt service), so that they will value their remaining 80 percent of the debt at:

$$[(1/3)\ 20 + (2/3)\ 80]/0.8 = 75,$$

an improvement of 5 (minus epsilon) over the valuation without buyback.[11] Intuitively, what has happened is that the country has bought out the pessimists

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[10] Krugman's example was used to claim the converse, namely that buybacks could be in the interest of the creditors who did not sell out only if the country was on the wrong side of the debt relief Laffer curve. He assumed, however, that all banks hold identical views. Unfortunately, relaxing that assumption alone does not allow one to show the potential gain to the remaining creditors in his particular example because that was constructed so that they in any event get full repayment in the "good case." Since it was necessary to modify his example, other numbers have also been changed to make for less messy arithmetic.

[11] If the reader wonders why this looks different from the formulae in the preceding paragraph, the answer is that they contained comparable implicit terms that cancelled. Thus the optimists' valuation of their receipts without buybacks is:

$$[(1/3)\ 30\ (0.8) + (2/3)\ 90\ (0.8)]/0.8 = 70.$$

at a price which the optimists (and presumably the country) believe to be unrealistically low, thereby leaving those who remain better off. When the good outcome is in any event not good enough to ensure full repayment, it is the optimists who reap the benefit. When (as in Krugman's original example) the good outcome is in any event good enough to finance full debt service, it is the country that gains. (Its welfare is unchanged in the example given. In both cases it uses its reserves and its surplus for debt service.) When, as generally occurs in reality, the potential outcomes straddle both possibilities, both parties may gain.

We thus have a second potential source of gain for those banks that remain. (Note that the good and bad outcomes were exogenous in the example—i.e., we abstracted from the incentive effects whose results are portrayed by the debt relief Laffer curve.) Its existence depends on banks in fact being willing to sell out at very different prices.

It is well known that the secondary market for bank loans is extremely thin. The market scarcely existed prior to the debt crisis. It has been expanding rapidly since, but the estimated 1987 turnover of something over $10 billion is still small relative to the stock of outstanding debt. The thinness of the market reflects a lack of demand. Most transactions take the form of swaps rather than sales. The demand for loan purchases is limited to foreign investors wishing to take advantage of debt/equity swaps, to the occasional bank wanting to on-lend to local clients, and to the odd company seeking to prepay local-currency liabilities cheaply. A bank that is determined to sell its loans has to be prepared to push the price down. One advantage of debtor buybacks is, of course, that they would add to demand and could thus speed the exit of banks that are not prepared to stay in for what may prove a very long haul.

The willingness of some banks to sell at a distress price implies little about the value placed on loans by other banks. It is indeed difficult to imagine that most banks anticipate receiving on average (after netting out new money) only 50 percent of the interest owed by Mexico, but that is what is implied by the recent price of Mexican debt (see the appendix).

Several reasons may account for the apparent large discrepancies in the value attached to LDC loans by different banks. Probably the most important is their differing views regarding the future prospects of the debtor countries, the factor emphasized in the preceding discussion.

This is not, however, the only possible reason. For example, the earlier analysis of the future path of a debtor's surplus available for debt service started off by considering two cases in which there was no room for differing opinions on the part of banks because the future path of the surplus was assumed to be known with certainty. Banks might nonetheless have different attitudes regarding their willingness to lend if they used different discount rates in weighing the future.

Several institutional factors are probably more important than different discount rates, though less important than differing views of the future path of the surplus, in motivating some banks to be more willing than others to sell their loans with large discounts (or otherwise exit with a sacrifice of present value). One arises from the existence of loan management costs. The legal documentation involved in rescheduling and lending new money to sovereign debtors is complex, and the cost of reviewing and processing it is much the same whether a bank has one hundred thousand or one hundred million dollars of exposure. Banks with very small exposures thus have a strong incentive to sell off their loans on the secondary market (or seek other forms of exit) even if the price is so low as to imply substantial debt relief. This is reinforced by a widespread belief that the stock market "rewards" banks that are able to declare that they no longer hold any Latin American debt.

A second reason arises from differing corporate strategies. Some banks are heavily committed to maintaining relationships with certain debtor countries, even to the point of owning a local bank with a network of branches. Such banks will be far more reluctant to sell their sovereign loans than those that have no other relationship to the country in question (although banks with a close involvement may also have opportunities denied to other banks for changing the form of their relationship through debt/equity swaps).

A third reason arises from the fact that banks are domiciled in different countries, each of which has a distinct taxation and supervisory regime. Required reserves are much higher in some countries (e.g., Sweden) than in others (e.g., Japan). The debtors against whom banks are required to hold reserves also differ from one creditor country to another. And the tax deductibility of specific and general provisions against sovereign loans varies greatly among creditor countries, with Germany and Switzerland perhaps the most generous and Japan and Singapore at the other extreme. Such differences give some banks stronger incentives to sell certain loans than other banks have, and so the prices at which different banks are willing to sell will vary.

A fourth reason is that the financial strength of banks varies, partly as a consequence of the international differences noted in the previous paragraph. Some have adequate reserves, either general or country-specific, to enable them to sell loans on the secondary market without financial embarrassment, should that seem to them wise. Others may be constrained from action that would weaken their balance-sheet position, even if that appears to them to be the rational course.

Economists will tend to ask: if some banks really believe that loans are worth substantially more than their secondary market value, why do they not enter the market and buy these bargains? Why do we not observe buy-outs? The principal reason would seem to be that most of the optimistic banks are already overexposed. A bank may refuse to sell its existing loans at a price that it regards as far below their true value, but still feel that it would be imprudent to add further to its exposure. An additional reason might be a fear that claims bought on the secondary market would appear less legitimate than the original loans, possibly undermining the willingness of the debtor to make the sacrifices needed to maintain debt service (Rotberg 1988, 8).

Before one concludes that voluntary debt relief is in everyone's interest, one must recognize that it will not always be in the *debtor's* interest. Debt buybacks (and some other methods of voluntary debt relief—see section 4) involve the use of reserves. When a country's output and investment levels are constrained by a shortage of foreign exchange, it is entirely possible that reserves would be better used for expanding domestic investment than for extinguishing foreign debt (a point made forcefully and elegantly by Froot 1988). In judging whether or not buybacks are the best use of available reserves, a country will need to take into account both the secondary market price at which it can buy back its debt and whether it is foregoing marginal domestic investment projects that would be net generators of foreign exchange. With a discount of 50 percent, the return (entirely in foreign exchange) may be calculated as 18 percent (given a nominal interest rate of about 9 percent), suggesting that buybacks would be quite an attractive use of foreign exchange.

This calculation would not be accepted by Dooley (1988a, 1988b) or Bulow and Rogoff (1988), whose central argument can be presented in terms of figure 2.[12] The *average* cost of debt, which is what they argue a country must pay to buy back its debt on the secondary market, is given by a ray from D to (say) L. The saving of debt service that results is given by the slope of the curve *DRLC*, the "*marginal* cost of debt," which at point L is zero. In this case the whole benefit of the buyback thus accrues to the creditor, while the debtor has benefits less than the cost at any point to the right of R. The distinction between the average and marginal cost of debt arises when the new money needed in "bad" states of the world amounts to a permanent partial forgiveness of interest, rather than its postponement. This is clearly a possible outcome, but those who do not regard it as a central expectation will conclude that the distinction between the average and marginal cost of debt is not of great import.[13] On the other hand, this analysis abstracts from both of the factors cited above to justify the belief that buybacks can bring mutual gain—the incentive effects summarized in the debt relief Laffer curve (which imply that a gain to the banks is not necessarily a loss to the country) and the differing views of different banks (which imply that the cost of a buyback is likely to be less than the average cost of debt).

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[12] Figure 2 is being used simply to portray the relationship between the level of the debt and the return investors expect from holding it. These authors do not acknowledge the incentive effects that may lead to the downward-sloping segment *LC*, but rather emphasize the positive but diminishing option value of holding higher levels of debt. This leads to a positive but flattening slope, as in the segment *RL*.

The marginal–average distinction does suggest that the return to buybacks may be less than implied by the formula (interest saving) ÷ (one minus discount), especially for countries whose debt trades at a high discount. However, it will not be drastically less except in the case of a country the nominal value of whose debt is of no consequence in determining its debt-service obligation. Most countries should find the returns on buybacks and other exit vehicles attractive.

4 *Alternative Mechanisms for Voluntary Debt Relief*

The most straightforward mechanism for securing voluntary debt relief is the *buyback*. Its disadvantage is that it requires a debtor to have in hand the foreign exchange to buy its debt on the secondary market.

An alternative approach is to swap, or defease,[14] loans into *exit bonds*. An exit bond was defined in Bergsten, Cline, and Williamson (1985, 181) as "a long-term bond carrying a low interest rate, which would bestow on the purchaser the right of exemption from participation in further rescheduling and coordinated lending exercises. These bonds would not themselves be rescheduled, nor would they be counted as a part of the base that determines the obligation to put up new money."

This definition is too narrow because it takes for granted that debt relief has to be given via a concessional interest rate, whereas the Mexican precedent showed that it could also be provided by new bonds being swapped with outstanding loans at a discount from face value. In the Mexican case, for example, existing bonds were traded in at an average discount of 30 percent, so that $1 of new bonds replaced $1.43 of old loans, but the interest rate on the new bonds is actually slightly higher. The only previous attempt to issue exit bonds, by Argentina in mid-1987, involved swapping at par, a concessional interest rate of 4 percent, 25 years' maturity, and 12 years' grace. Only five banks elected to take bonds on those terms.

One broad distinction among exit bonds is thus whether they provide the concession to the debtor in terms of the interest rate or in terms of the value of the bond issue. But the more important question is whether they carry guarantees or other forms of "credit enhancement." If so, these guarantees may apply to either the principal or the interest payments or both; they may be partial or total; and they may be provided either by some outside benefactor or by the country buying financial assets to serve as collateral. The Mexican bond issue carried a total guarantee of the principal provided by Mexican purchases of US Treasury zero-coupon securities with a maturity identical to that of the Mexican bond issue (20 years).

To the extent that exit bonds are neither guaranteed by an outside agency nor collateralized, the question arises as to whether their interest and/or principal payments are senior to those on existing loans. The seniority of interest was left obscure in the case of the Mexican defeasance scheme. Morgan Guaranty and the US Treasury apparently assured the banks that the new loans would not be senior, while Mexican officials reportedly stated the contrary. Any such seniority could only represent a policy intention by the authorities, since no request was made for legal subordination of existing debt—a request that would have required approval by every creditor bank. Such intentions cannot provide a completely credible guarantee to the creditor, whatever the commitments of the debtor, owing to the sharing clause, which entitles all creditors to share equally any disproportionate payments they may receive. This clause could provide the basis for a legal challenge by disgruntled banks to the banks that had bought exit bonds if other loans were not being serviced.

Apart from buybacks and exit bonds, the third channel for voluntary debt relief is the conversion of loans into *local currency for equity investment*. This usually involves restrictions on the right to remit profits for several years, and even longer restrictions on the right to sell out and remit the capital. The central bank typically buys back the loans below par, thus capturing a part of the secondary market discount. The price at which it buys the debt back has sometimes been determined by an auction.

It would doubtless be possible to conceive of intermediate proposals. For example, loans might be converted at a discount into bonds whose future debt-service payments would be paid in local currency to be used for equity investment. However, the alternatives identified above would seem to provide an adequate basis for analysis.

In addition, there may be possibilities for mutually beneficial debt reconstruction that do not involve debt relief, but that seek instead to rearrange payments obligations with reference to exogenous contingencies. The leading example is commodity-linked bonds. These might, for example, cut the interest rate due unless the price of some major export commodity rose beyond some threshold, above which the interest rate could rise progressively until it was higher than the present contractual rate. If the terms of such a bond were chosen so that the expected present value of contractual payments did not diminish, no debt relief would be involved. The author has already argued in favor of such proposals (Lessard and Williamson 1985), but they will not be considered further in the present study.

OPTIMAL USE OF RESERVES

Several issues arise in choosing among these alternatives. A first is whether the country has foreign exchange available. If it does, then it has the option of buying back debt on the secondary market or issuing bonds whose debt service is at least in part collateralized, in addition to the options available to countries that do not have spare reserves (analyzed subsequently). Before committing itself to the use of foreign exchange to buy back loans or collateralize bonds, the debtor will need (as noted in section 3) to assure itself that this is a better use of foreign exchange than the import of investment goods to increase domestic capital formation. This will depend both on the size of the discount on the secondary market and the rate of return on additional domestic investment.

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[13] Bulow and Rogoff (1988) also point to the Bolivian buyback as evidence. Bolivian debt rose from a price of 6 cents on the dollar, before a buyback was rumored, to 11 cents after it had taken place, resulting in a minimal fall in the total market value of Bolivian debt. They interpret this as implying that the market had an unchanged view of the level of debt service that Bolivia could and would pay, which the buyback simply spread over a smaller number of claims. My interpretation is different: that the buyback resulted in the elimination of the most pessimistic holders. Buying these out could be advantageous to Bolivia even if the result was to *increase* the total market value of its debt, which does not reflect (and still less determines) Bolivia's short-run payments, which are zero, but rather the date at which payments are expected to resume. By advancing that date and reducing the cost of resuming payment the buyback has benefited both the nonexiting banks and Bolivia.

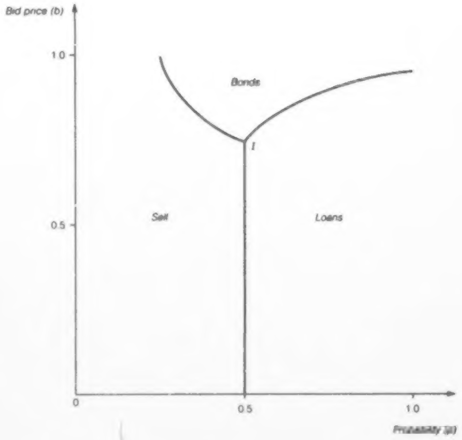
[14] Defeasance is defined as the replacement of one bond issue by another.

The appendix contains a detailed comparison between buybacks and defeasance on the Mexican model, involving collateralization of the principal. It is also possible to conceive of a country placing funds in an escrow account in order to collateralize a part of the interest.

The appendix shows that under certain assumptions a banker's choice between holding on to loans, swapping into principal-collateralized bonds, and selling on the secondary market depends on two critical variables, *b* and *p* in figure 3. The variable *b* on the vertical axis is the "bid price" for a loan/bond swap—the number of cents on the dollar at which a bank offers to swap its existing loans for defeased bonds. (The average value of *b* for the bids that Mexico accepted was 0.7—i.e., 70 cents of new bonds were issued for each dollar of old loans.) The variable *p* on the horizontal axis is the probability that the banker attaches to interest on outstanding loans actually being paid in any period. (It is assumed that this probability is constant in each future period, but a variant on this assumption considered in the appendix provides some reassurance that the results presented below are not sensitive to this specification.)

Clearly the choice between holding on to loans and selling on the secondary market does not depend on *b*, so the boundary between those two alternatives is a vertical line. In fact, it is a vertical line at that probability *p* equal to the price on the secondary market. That is, any bank that estimates that the probability of receiving interest in any future year is less than the price on the secondary market will prefer to sell off its loans, while any bank that thinks the probability is higher will prefer to retain its loans. It seems rather extraordinary that banks should regard the probability of receiving interest from Mexico in any future year as no better than 50 percent, but this is what the secondary market price of 50 cents on the dollar implies. However, that is also the price at which most banks have chosen *not* to sell, which makes it clear why they would have a legitimate grievance if some mandatory scheme were to oblige them to sell out at or near that price.

FIGURE 3 **Bankers' preferences among retaining loans, swapping into collateralized bonds, and selling on the secondary market.**



If the country is willing to offer a swap into collateralized bonds at a sufficiently good rate (i.e., high value of *b*), then such a swap will be preferable either to sale on the secondary market or to retention of existing loans (figure 3). If interest on bonds is senior to that on existing loans, this will tend to expand the area where bonds dominate in figure 3 by reducing the vertical height of the intersection point *I*, flattening the boundary between

the "bonds" and "sell" segments, and steepening the boundary between the "bonds" and "loans" segments. In the limit, if interest on the bonds were judged to be free of default risk, the boundary between the "bonds" and "sell" segments would be horizontal. If the interest rate were identical on the defeased bonds and on the old loans, the vertical coordinate (*b*) would be identical to the horizontal coordinate (*p*). When, as in the Mexican scheme, the interest rate on bonds is higher than that on loans, it would actually pay a bank to bid a price (*b*) *lower* than that at which it could sell on the secondary market in order to switch into bonds.

The attractiveness to the debtor of securing a switch from loans into bonds depends on how low a price (*b*) the banks will bid to get rid of their loans, and also (inversely) on the size of any premium on the interest spread on bonds as opposed to loans. In addition, the defeasance alternative tends to appear more attractive to the debtor when the social discount rate it uses to discount foreign exchange is relatively low.[15] Clearly the option of buybacks tends to appear more attractive the lower is the price on the secondary market.

When one combines the analysis of the interests of the creditors and the debtors, it emerges that there are two circumstances which can cause defeasance to appear preferable to buybacks. One is when the banks believe that interest payments on the defeased bonds carry seniority over those on loans; this can motivate a bank to make an attractive (low) bid *b* to swap into bonds. The other is when the debtor discounts foreign exchange at a relatively low rate.

The analysis in the appendix shows that, given that the bankers appear to have attached little credence to Mexican assurances that interest on the collateralized bonds would be treated as senior, the Mexican approach was more cost-effective than buybacks would have been only for discount rates below 14 percent. This is on the low side for plausible estimates of social discount rates for foreign exchange in payments-constrained countries, suggesting that buybacks are probably (though not unambiguously) a more cost-effective use of foreign exchange. The one factor that could clearly tilt the advantage toward bonds is seniority.

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[15] This is because the bulk of the pecuniary gain to the debtor from defeasance takes the form of reducing the principal of the debt rather than saving interest, and this benefit accrues only 20 years in the future.

UNCOLLATERALIZED EXIT BONDS

Countries that do not have spare reserves to use in buybacks or as collateral will have to rely on exit bonds and/or debt/equity swaps to secure voluntary debt relief. Uncollateralized exit bonds will certainly require some form of credit enhancement—either guarantees or convincing seniority—if they are to be accepted by banks on terms that confer any worthwhile degree of debt relief. Very few banks will be prepared to accept a major reduction in the present value of their claims unless they believe themselves to be getting a markedly more secure asset in return. The minimal response to the offer of exit bonds on the 1987 Argentine menu was to be expected.

Unfortunately, however, it is very difficult for a country to make a credible unilateral commitment to seniority, for two mutually reinforcing reasons. First, the *pari passu* clause in existing loan contracts forbids the legal subordination of those loans to new instruments, and a waiver of that clause requires *unanimity* on the part of the banks. It seems highly unlikely that each of the hundreds of creditor banks could be persuaded to agree to such a waiver, since each bank correctly perceives such a waiver to weaken its position vis-à-vis other creditors.[16] Hence any seniority has to be de facto (as in the seniority granted to bonds and World Bank loans) rather than de jure. The second difficulty is that it is precisely such informal promises that may sound unconvincing to a creditor when they are advanced in a manner that does not seem to accord with the natural interest of the debtor. And the purchasers of exit bonds, by declaring their desire to cut their ties with the debtor, are clearly not the creditors whose future goodwill a debtor can be expected to go out of its way to nurture.

One might therefore wonder whether it would be possible to establish seniority by introducing as an intermediary some international institution that already enjoys de facto seniority, such as the World Bank. If the World Bank accepted responsibility for collecting the debt-service payments on exit bonds, and then distributed its receipts to creditor banks, could it extend de facto seniority to the exit bonds without placing its own capital at risk? It seems that this is unlikely. Action as a mere agent would probably not suffice to establish credible seniority, which is based on the implicit consent of all other creditors. On the other hand, if the Bank became the lender of record or allowed exit bonds to be shaped as B-loans in a cofinancing arrangement, creditor banks would have a claim against the World Bank in the event that debt service was not maintained on schedule. Thus if the Bank is to be involved in the issue of exit bonds it might as well involve itself in an obvious and straightforward way, and use its guarantee authority explicitly.

DEBT/EQUITY SWAPS

Consider finally the option of converting a loan into local currency for equity investment. Even when the country purchases its debt back at less than 100 cents on the dollar, a debt/equity swap is not necessarily a good bargain for the debtor. If the investment would have been made anyway, the country ends up repaying debt prematurely rather than enjoying an inflow of free foreign exchange. So far as the country is concerned, the decisive issues in appraising the desirability of a debt/equity swap can be summarized (Roberts and Remolona 1987) as:

- the proportion of the secondary market discount that the country can succeed in commanding
- the degree of additionality in the direct investment that occurs
- the economic value of the additional investment attracted (e.g., whether it generates foreign exchange or uses abundant resources)
- the pressure on the money supply or, more fundamentally, on real resources caused by the issue of additional currency (a pressure that is absent when the funds flow into newly privatized assets).

Debt/equity swaps were initially envisaged primarily as a mechanism for encouraging direct investment. This led to an assumption that the debtor country should seek to capture only a part of the secondary market discount, leaving the rest as an investment incentive. It also led naturally to concerns about additionality and the economic value of the resulting investment, since one does not wish to subsidize investments that would happen anyway, nor those that neither absorb abundant factors nor generate foreign exchange. However, unless a government has considerable confidence that it can identify particularly worthwhile investments *ex ante*, it may be more sensible to treat debt/equity swaps simply as buybacks in exchange for local currency (with adequate assurance that the investment will stay in local currency, provided by the restrictions on remittance rights). This viewpoint suggests first determining the level of foreign investment that the economy can absorb comfortably, and then auctioning off that amount of local currency in exchange for debt. This will ensure that most of the secondary market discount is captured by the debtor country.

Essentially the same outcome could be achieved by allowing direct investment to enter in the conventional way at the market exchange rate and then using the proceeds for buybacks, assuming that this were allowed. To the debtor country, this procedure would have the advantage of retaining flexibility as to whether to use the proceeds in buybacks rather than in expanding imports. A debt/equity program thus makes sense only (1) if the country is not allowed to buy back its debt; (2) if the inflow of foreign exchange from direct investment would otherwise be preempted for debt service; or (3) if the country wants to subsidize at least some forms of inward direct investment.

5 *The Design of Voluntary Debt Relief*

If all parties have a strong common interest in the facilitation of voluntary debt relief, how can one explain the minuscule scale on which voluntary debt-relief mechanisms have been implemented to date? Four possible reasons come to mind.

The first may be called "catch 22." If a country has the money to buy back a significant volume of debt on the secondary market, then it must also be able to service its debt. But so long as it is servicing its debt, one might expect that the discount at which its loans would trade on the secondary market would be too modest to offer worthwhile debt relief through buybacks.

In fact, Mexican debt has recently traded at a discount as high as 50 percent, despite Mexico having serviced its debt faithfully since 1983 and despite the substantial volume of reserves that Mexico has built up, a part of which could be used for buybacks or other mechanisms that provide debt relief. Presumably this paradox can be explained by concerns that Mexico may not continue to service its debt as punctiliously in the future as it has since 1983 (a concern fostered by, among other things, some statements of President-elect Carlos Salinas de Gortari). Venezuelan debt has also traded at a substantial discount (around 45 percent) despite continued payment of interest, net amortization of over $5 billion during the 1983–87 period, and substantial reserve holdings. These examples suggest that the catch 22 may not be absolute.

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[16] Froot (1988) shows that an exception could arise if *every* bank were convinced that a country was over the top of the debt relief Laffer curve, but unanimity on this point seems distinctly improbable.

A second possible reason is past underestimation of the likely persistence of the debt problem. When the debt crisis first broke, fears for the stability of the international banking system were combined with hopes that the debtor countries might be able to regain voluntary access to capital markets relatively quickly provided that their immediate liquidity problems were contained. This made it rational for banks to reschedule and provide new money, but not to accede to proposals for more fundamental changes like capitalization of a part of interest. As long as banks retained the hope of a relatively rapid normalization of relations with sovereign debtors, the liquidity relief that they regarded themselves as providing was limited. This in turn meant that most banks were reluctant to provide much in the way of debt relief.

A third possible reason for the past lack of voluntary debt relief may have been the perception of a free-rider problem. Cline (1984, 75) provided the definitive analysis of how any bank sufficiently small to believe that its individual action will have no influence on the probability of default has an incentive to avoid new lending (and indeed rescheduling, although that is usually more difficult). If many banks act on their perceptions of individual self-interest, however, it will prove impossible to mobilize the funds that are needed to permit debtors to maintain interest payments. Prevention of free riding has required the dragooning of all banks into the extension of new loans. Any opting out was regarded as a threat to the cohesion of the bank syndicate.

The fourth possible reason concerns the danger of moral hazard, which arises with schemes for voluntary as well as comprehensive debt relief. Debtor countries would still have an incentive to cast doubt on their continued ability or willingness to service debt, so as to reduce the price at which they could buy back their debt on the secondary market or enhance the attractiveness of other instruments that confer debt relief.

It seems to be widely believed that these considerations preclude a major role for voluntary debt relief in the resolution of the debt crisis. It is often conceded that mechanisms like debt/equity swaps or buybacks may have a useful role at the margin, but nothing more. In fact, the four possible explanations for the modest scale of voluntary debt relief in the past do not necessarily imply that its future role need remain so circumscribed. It has

already been pointed out that catch 22 looks more conclusive in theory than it seems to be in practice. Second, most banks have by now recognized that the problem is an enduring one and that they cannot realistically anticipate a return to voluntary lending in the foreseeable future. Third, the free-rider charge is inapplicable provided that creditors who exit do so at a price, by providing debt relief. Moral hazard remains a key issue, but it is one that it may be possible to address through the appropriate design of proposals.

FACILITATING BUYBACKS

The changes that need to be made in order to promote buybacks are the removal of legal obstacles and the provision of sufficient financial leeway to allow countries to exploit their new legal freedom.

It is not altogether clear whether buybacks are presently precluded by the mandatory prepayment clause in loan contracts, which requires that any prepayment must be done ''ratably'' (i.e., that all banks must be repaid proportionately to their exposure), or by the sharing clause, which requires banks to share proportionately any disproportionate payments they receive. In the case of Bolivia, the banks agreed to waive these clauses so as to remove any doubts. Other countries that have made modest buybacks of public or publicly guaranteed loans are believed to have done so by using state agencies other than the original borrower as the purchaser, with a view to avoiding any possible challenge. In any event, the present situation is sufficiently ambiguous to make it desirable for the banks to be asked to provide waivers as a means of facilitating buybacks, as they are reportedly planning to do with Chile.

Suspension of the mandatory prepayment and sharing clauses requires the consent of all the creditor banks, but their approval in response to a recommendation from the Bank Advisory Committee may nonetheless be expected since individual banks do not perceive themselves to be worsening their position vis-à-vis other creditors. The Committee might make an annual recommendation in favor of such a waiver, perhaps up to a specified limit, whenever a debtor country was judged to be servicing its debt conscientiously. This would provide an incentive for the debtor to avoid actions that might reduce the value of its debt, thus providing at least a partial solution to the problem of moral hazard. It would also give the banks a way to reward responsible behavior.

The other prerequisite for buybacks is the availability of reserves. Even if the banks accept that discounted buybacks are in the interest of those banks that remain as well as that of the debtor and the exiting banks, they may find it difficult to agree to new money packages that explicitly provide cash for the debtor to finance buybacks. Banks are bound to be concerned about the propriety of lending new money that they will show in their balance sheets at face value if that money is used to enable the debtor to buy back old debt at a fraction of that value. A possible solution to this problem would be to earmark certain revenue streams for use in buybacks. From the banks' perspective, the ideal would be to avoid any diversion of income from debt service to buybacks. The earmarked streams should thus consist of revenues that would not otherwise have been available—like the use of funds specifically donated by sympathetic governments for the purpose of financing buybacks, as occurred in Bolivia.

Since donor governments are unlikely to donate earmarked aid for buybacks, except in a situation as extreme as that of Bolivia, it will probably be necessary for the banks to accept some compromise with their ideal and accept the earmarking of revenues which might have been available in any event. It would still be sensible to seek revenue streams that are particularly sensitive to policy actions by the debtor country, for incentive reasons. Promising candidates would be the repatriation of flight capital, inward direct investment, and a proportion of the increase in revenues from nontraditional exports.

The earmarking of specified revenue streams as legitimate sources of finance for buybacks does not seem to confront any legal problem, since the country would not be pledging itself to use particular revenues or assets for buybacks. The earmarking would be accomplished by the earmarked revenues being disregarded in the negotiations between a debtor and its Bank Advisory Committee regarding the necessary scale of new lending.

LAUNCHING EXIT BONDS

It was argued in section 4 that successful issue of exit bonds will require either collateralization, guarantees, or convincing seniority. Collateralized exit bonds seem rather pointless, since the reserves they require can be used as or more efficiently in a buyback program.[17] Seniority is impractical because a waiver of the nonsubordination clause requires the unanimous consent of the lending banks. The most promising possibility thus involves guarantees.

The central question concerns who would provide the guarantees. The obvious candidate is the World Bank. The Bank was given the legal authority to issue guarantees in its original Articles, though it has never used those powers on an extensive scale.[18] It has just received a general capital increase of $75 billion, giving it ample financial scope to launch a substantial guarantee program rapidly. It has the capacity and experience to impose some form of conditionality, which will surely be needed: no guarantor can sensibly provide guarantees without assurance that the debtor's policies will be such as to enable it to service its debts and avoid the guarantees being called. Finally, the Bank has a legal mechanism whereby it can give the exit bonds the de facto seniority that would provide the primary safeguard against the guarantee being called; that is, it can require a counter-guarantee from the debtor government and can insert an optional cross-default clause between that counter-guarantee and the rest of its loans.

Other features of Bank-guaranteed exit bonds are suggested below. Clearly many of the details could be varied, but it seems useful to lay out a specific set of proposals in order to illuminate the issues that will need to be resolved and demonstrate that reasonable solutions can be devised.

The exit instruments would presumably take the form of securitized bonds to facilitate their transferability. However, this does not seem a topic of decisive importance: a special loan issue could be substituted.

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[17] Press reports at the time of the Toronto Summit (June 1988) suggested that Japan had presented a proposal along these lines, which envisaged that a debtor nation agreeing to a structural adjustment program with the IMF should have the right to issue exit bonds corresponding to a part of its debt and should partially collateralize those bonds with a reserve account established at the IMF. Since the debtor country would be responsible for establishing the reserve account out of its own reserves (apparently with no input from either Japan or the IMF), this proposal is vulnerable to the same criticism of cost-ineffective use of foreign exchange as the Mexican defeasance scheme.

[18] There has been some legal question concerning whether guarantees that provide debt relief rather than induce new money are consistent with the requirement in the Bank's Articles that loans be made only for "productive purposes." The economics of the matter seem clear enough debt relief can indeed be expected to increase the level of productive investment in a country that is constrained by a shortage of foreign exchange. With the proper political lead the lawyers could doubtless be persuaded to adopt a legal interpretation consistent with economic reality.

The World Bank should not be expected to tie up a large part of its capital indefinitely in guaranteeing exit bonds. On the contrary, this should be a crash program that might absorb a large part of the leeway provided by the recent general capital increase over the next few years but would be phased out relatively quickly in order to release the Bank's resources for its conventional lending programs as these build up. One should therefore avoid a balloon repayment of principal at the end, which would impose a big contingent liability on the Bank for the full life of the exit bonds. The debt service on exit bonds should instead take the form of a series of equal payments covering both interest and principal (as in a mortgage).

The same consideration points to a relatively short maturity, at least for the guaranteed portion of the loan. This is also consistent with the need for some form of conditionality (a topic discussed further below), since not even the most fervent advocates of conditionality believe that this can provide any assurance of prudent policies for more than a few years in the future. The corresponding disadvantage is that it will provide little or no cash-flow relief to the debtor in the short run, which implies that any additional cash-flow relief will have to be provided by the banks that choose not to exit. These banks will have to realize that, at least under unfavorable contingencies for the country, they are bound to suffer a reduced cash flow in the short run. The attraction of an exit bond—for which the exiting banks are prepared to concede a fall in present value that will ultimately redound in part to the benefit of the banks that do not exit—is that it bestows seniority.

Suppose that the payment coupon on the exit bonds were set equal to the interest coupon on regular bank loans. If swapped at face value, this would leave a debtor's payments obligation unchanged: the purchasers of exit bonds would not provide cash-flow relief, while the nonexiting banks would be penalized (via a smaller base for new money requirements or higher interest capitalization) only to the extent that the country was unable to meet its full interest bill or as a result of a decision that more cash-flow relief was needed. The maturity of the World Bank's guarantee might be chosen so as to make the present value of the exit bond for a typical debtor roughly equal to the price on the secondary market, since this would then result in exit bonds and loans typically being swapped close to par (thus leaving debtors' payments obligations unchanged). With current interest rates (LIBOR + spread) of around 9 percent and secondary market prices of 50 cents on the dollar, this criterion implies a maturity of 8 years.[19]

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[19] $\sum_{t=1}^{8} 9/(1.09)^t = 49.8$.

The maturity of the Bank's guarantee need not necessarily be the same as the maturity of the exit bond. In fact, there is a strong incentive argument for structuring the exit bonds to provide for additional payments in the event that they suffer any payments interruption. For example, the bonds could initially be issued with 16-year maturities, with the first eight payments guaranteed by the World Bank and the remaining eight subject to cancellation, one year at a time, as the first eight were paid off on schedule. The resulting incentive for the debtor to maintain the service of these bonds would further reduce the probability that the Bank's guarantees would ever be called.

Suppose, therefore, that exit bonds promise to pay a fixed sum[20] to their purchasers each year for eight years (with the possibility of further payments if the eight guaranteed payments are not made on time). The process of issuing those bonds could be organized in two ways. One would be to fix the annual coupon payment on the exit bond and the price at which existing bank credits could be swapped into exit bonds, and issue the quantity of exit bonds that the banks want to take up at those prices. The alternative is to fix the annual coupon payment on the exit bond and the (maximum) number of bonds to be issued, and allow the banks to bid for the exit bonds. As with the Mexican defeasance scheme, these banks willing to bid attractively low prices at which they would swap their existing loans would have their bids accepted.

The second approach seems much more attractive. It avoids the need to guess prices that will entice the banks to exit. It does not give any official recognition to the secondary market price. (The banks themselves will doubtless take account of that price, since that is the main alternative mechanism for exit, but that does not raise similar problems.) Finally, by forcing the banks to compete for a limited volume of guarantees, it avoids any suggestion that public money is being used to bail out the banks.

In order to ensure that the World Bank used its guarantee authority only to purchase substantial debt relief, it should stipulate a maximum swap price at which its guarantee would apply. A requirement that debt relief be at least 35 percent might be reasonable. This would allow all the highly indebted countries a chance to issue exit bonds without requiring a further fall in prices on the secondary market, while ensuring that World Bank guarantees were not frittered away without purchasing a worthwhile degree of debt relief.

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[20] Alternatively, by analogy with a variable-rate mortgage, the sum due could vary each year by reference to the current level of LIBOR. Better still, it could vary with respect to an index of ability to pay, such as export revenue or export prices.

The Bank would also have to determine a maximum value for exit bonds that it was prepared to guarantee for any individual country. It seems pointless to try and invent any formula to guide this decision. Overall, if one estimates that perhaps one-third of the debt is held by banks that would be willing to sell out for a substantial discount (averaging 50 percent), the potential demand from the 17 highly indebted countries could amount to as much as $45 billion. A sum as large as this would strain the Bank's financial capacity under present plans, but any conflict with the lending program could be avoided by accelerating subscription of the $75 billion general capital increase already agreed.

In practice, the Bank should probably be guided by two factors in the decision as to how many exit bonds to guarantee. One factor is how much debt relief it is likely to be able to buy, for which it can get a clue from the price on the secondary market. The other is how confident it can be that the country will indeed service its exit bonds on schedule and not trigger the Bank's guarantee, which it will have to judge by the quality of the country's economic policies. It would be irresponsible, indeed dangerous, for the Bank to start guaranteeing debts above the level that it is confident a country will be able and willing to service.

This inevitably means that the Bank's guarantees will involve conditionality. The question is what form that conditionality should take. My own view is that it makes sense to concentrate on a limited number of strategic factors that ensure that no new disaster is in the making (and to involve the IMF as well as the Bank in judging whether policy is sustainable). Far better that the Bank should insist on an assurance that debtors are implementing a responsible fiscal strategy and maintaining a competitive exchange rate than that it buy more promises that trade restrictions will be dismantled or state enterprises privatized. In addition to reinforcing elementary prudence, perhaps the Bank should pursue the idea of a "debt-for-nature" bargain urged by environmental groups. The creditors whose guarantees are being used do, after all, have a material interest in limiting the greenhouse effect and species extinction and thus in curbing the destruction of tropical forests.

Having developed a proposal, it is natural to try to anticipate some of the arguments that might be developed in criticism. First, the Bank has customarily sought to avoid using its guarantee authority because of the potential conflict with its lending program, which it regards as its primary activity. (Guarantees count dollar-for-dollar against the Bank's callable capital, just like loans; they differ, however, in that they impose no requirement to raise cash from the private market.) The answer is that a temporary program of guaranteeing exit bonds need not obstruct the regular lending program. Assuming an average discount of 50 percent, conversion of $90 billion (one-third of the bank debt of the seventeen highly indebted countries or about 23 percent of the banks' total LDC debt) into guaranteed exit bonds with an eight-year maturity in a four-year program would impose a maximum claim against the Bank's capital of $37 billion at the end of the fourth year (declining to $31 billion after 5 years and zero after 12 years.) If subscriptions under the general capital increase are paid in on an accelerated schedule, commitments on that scale would not constrain the Bank's lending program until long after the new sustainable lending level of $22 billion had been reached, if ever.

Second, it will doubtless be claimed that a decision to use the Bank's guarantee authority would jeopardize the chance that the US Congress will ratify the US contribution to the general capital increase (which has still not been approved as this goes to press, though enough other countries have ratified for the increase to take effect). In fact, however, the complaint of some congressional critics has been that the World Bank was not playing any role in resolving the debt crisis by catalyzing debt relief from the banks. Exit bonds would do exactly that—admittedly not on the comprehensive basis that the congressional critics have envisaged, but no less effectively. A program of World Bank guarantees for exit bonds thus ought to help secure, rather than jeopardize, congressional ratification of the general capital increase.

Third, it may be suggested that there exist more suitable guarantors than the World Bank. For example, Shafiqul Islam (1988) has argued for a reconstruction of bank claims into long-term bonds with concessional interest rates that would be guaranteed by the main surplus countries, Japan and West Germany, rather than by the World Bank. However, a current account surplus is an irrelevant criterion for selecting a guarantor: a credible guarantee requires positive net worth, not a positive flow of funds. The World Bank's capital is distributed roughly in proportion to countries' financial strength, and is thus a more suitable base against which to match the role of guarantor. Moreover, the Bank has the experience to impose conditionality and a continuing relationship with the debtors that should provide assurance that the exit bonds will be treated as senior.

Fourth, parts of the Bank's bureaucracy will fret about the danger that its creditworthiness will be eroded and its cost of borrowing will rise. This may conceivably occur, but on a very limited scale. The impact can hardly be large, since the ultimate security of those who lend to the Bank is provided by the callable capital contributed by the industrial countries rather than the quality of the Bank's loan (or guarantee) portfolio. A modest service charge could easily ensure that the Bank's other clients benefit financially, rather than being penalized, by its role in guaranteeing exit bonds. The Bank needs to worry more about furthering the purposes for which it was founded and less about achieving results that impress the graduates of finance schools.

A POSSIBLE SUPPLEMENT TO VOLUNTARY APPROACHES

Calculations made in the next section suggest that the voluntary measures discussed above—buybacks and exit bonds—should suffice to bring significant relief to the cash-flow position of all except the most hopelessly indebted countries, eventually. Unfortunately, that relief will be about a decade in coming, so a more rapid resolution of the debt crisis will remain dependent on export growth. One can of course hope that stabilization of the debtors' financial prospects would ease the process of raising new money, encourage the repatriation of flight capital, and improve the prospects for other forms of capital inflow. Nevertheless, it is prudent to give some consideration to measures that might supplement the voluntary approach, should the need arise.

That need could arise for several reasons. The world economic environment might change for the worse. The process of assembling new money packages might finally collapse, as has repeatedly been feared. Voluntarism may prove insufficient for countries in a particularly difficult situation. The political climate could change, leading to a commitment to achieve rapidly a definitive solution to the debt crisis.

What would be desirable is a mechanism that would face the banks with an unambiguous choice between greater security and faster repayment at the cost of a reduction in present value, on the one hand, and maintenance of the present value of contractual claims at the cost of a delay in repayment, on the other. The key to this would be a reconstruction of the debt of the nonexiting banks on terms that the debtor countries could reasonably be expected to live with under a wide range of circumstances. Such a reconstruction would need to provide adequate liquidity relief even if payments outcomes turned out worse than hoped. This would provide a solution to the problem of debtor moral hazard, since access to voluntary debt relief could be made conditional on the debt continuing to be serviced in accordance with the new commitments. Note also that confidence of full future debt-service payments need not preclude volunteers from providing debt relief once the possibility of free riding is suppressed and it is unambiguously established that banks that do not give debt relief can expect to wait a long time to get their money back.

Such a definitive debt reconstruction would clearly require the consent of the bulk of the banks, acting through the Bank Advisory Committee. This consent is unlikely to be forthcoming unless the banks believe that the debt reconstruction will leave them at least as well off as they could expect to be under existing arrangements. In principle it should be possible to meet this requirement, given the two potential sources of gain to the nonexiting banks analyzed in section 3: the incentive effect of debt relief (the debt relief Laffer curve) and the income transfer from the banks that choose to exit. But the banks will have to recognize that their cash flow is likely to be squeezed for some years, until the exit bonds have been paid off, since it is the nonexiting banks that will be expected to provide cash-flow relief in the short run.

If the net interest (after receipt of new money or interest capitalization) that a country is expected to pay is to vary so as to provide adequate liquidity relief under a wide range of circumstances without the need for negotiation, it will be necessary to agree on a formula to govern the payments obligation. The simplest candidate is a formula linking payments obligations to the value of export receipts. This has the virtue both of ensuring that the creditors benefit from improved export performance and of protecting the debtors from a deterioration in the world environment. The way to reconcile a payments obligation linked to payments capacity with maintenance of the present value of the contractual claims of the creditors is to capitalize any excess of interest charges over the payments obligation. If some or all banks prefer to retain the form of new money packages, presumably they could devise a corresponding formula for their new money obligation.

One specific way to implement this approach would be to specify the debt-service *payments* due in any future year as an agreed sum that the country was capable of servicing on the basis of its export performance in some base year, plus some proportion of *incremental* export revenue[21] over the value

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[21] Provided that adequate statistics are available, it would seem logical to include revenue from exports of goods, services, and transfers. In principle, a case can be made for tying debt-service charges to variables that have an important influence on export revenue but that are entirely exogenous to the country involved, such as the prices of important primary commodity exports, so as to avoid the disincentive effect of tying debt service to exports. However, the practical problems of devising a measure that can be relied upon to track aggregate ability to pay suggest that such an approach would be difficult to employ in comprehensive debt reconstruction (as opposed to future voluntary lending or restructuring of individual claims: see Lessard and Williamson 1985).

in the base year. (If export revenue falls below that of the base year, presumably the debt-service payment might also fall.) This bears a resemblance to proposals to limit debt-service payments to a proportion of exports (option 17 in Bergsten, Cline, and Williamson 1985), but it is more flexible in that the proportion of *additional* export revenue to be devoted to debt service can be set higher than that in the base year. This should help to reconcile the need of the debtors for significant cash-flow relief as long as circumstances remain bad with the creditors' desire to have a substantial stake in any future upturn in the debtors' fortunes. It also bears a resemblance to the limit on debt service to 10 percent of export value decreed by President Alan Garcia of Peru, but differs in the additional and fundamental sense that it is a proposal for mutually agreed debt reconstruction rather than for unilateral action.[22]

It is the essence of this proposal that debt-service *charges* would be distinct from current payments obligations. Charges would continue to be based on the value of debt outstanding. Both interest and amortization could continue to be assessed in essentially the same way as at present. But any excess of interest charges over debt-service payments due would be capitalized. Similarly, all maturing debt would be automatically rolled over except when debt-service payments exceeded the interest charge.[23]

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[22] The proposal is (almost) a combination of option 16 (interest capitalization instead of new money) and option 17 (payments based on exports) considered in Bergsten, Cline, and Williamson (1985). At that time we did not recommend adoption of such options, which we argued would delay the return of debtor countries to normal access to capital markets, but instead treated them as contingency plans for possible utilization in the event of a deterioration in the debt situation. Unfortunately, there is no sign of a restoration of normal market access for most debtor countries. Meanwhile the ability of the banks to accommodate solutions that involve reductions in reported earnings has improved, while evidence has increasingly suggested that reported earnings are of much less significance than previously assumed. It is these developments that justify considering the use of some of the contingency measures that were previously deemed undesirable.

[23] These ideas are easily expressed in algebra. Debt service payments due in year t, P_t, would be

$$P_t = \alpha + \beta (X_t - X_o)$$

where α is the sum the country was capable of servicing in the base year, β is the percentage of incremental export revenue to be devoted to debt service, and X_o is the value of export revenue in the base year. Debt service charges, C_t, would be

$$C_t = (i + a) D_t$$

where i is the interest rate, a is the amortization rate, and D is the outstanding value of debt. The value of the debt would change according to the formula

$$D_{t+1} - D_t = iD_t - P_t$$

The aim would then be to select the crucial parameters—the debt service that the country was capable of handling in the base year and the proportion of its incremental export receipts to be applied to servicing debt—so as to leave the debtor with an adequate short-run cash flow and the nonexiting banks at least as well-off in the long run as they could expect to be under present arrangements and with present export prospects. To the extent that export prospects improve because of better incentives facing the debtor country, the banks can expect to benefit eventually. To the extent that some loans are bought back cheaply on the secondary market, more debt service will ultimately be available for the banks that remain. To the extent that some banks buy exit bonds, the remaining banks will have to capitalize a higher proportion of interest in the short run, but this will be compensated by the greater interest receipts they can expect in the long run after the exit bonds are paid off. (Banks that are not compensated by the expectation of greater long-run interest receipts will be the ones that choose to exit.)

Provided that some banks are sufficiently impatient or pessimistic about the prospects of debtors as to be willing to exit for prices below the present value of expected debt service, the banks that remain can expect to receive a stream of earnings with a higher expected present value as a result of capitalization plus the facilitation of voluntary debt relief. However, the expected present value of future earnings is not necessarily the primary concern of accountants and regulators.

The accounting and regulatory implications of interest capitalization and of payments linked to exports were evaluated in Bergsten, Cline, and Williamson (1985, 157–58, 168). It was concluded that in both cases the American accounting profession would be likely to take a view that would result in a reduction in the reported value of bank profits. In the case of a combined scheme, it would seem highly unlikely that the accountants would allow accrual into profits of that portion of interest charges in excess of interest receipts.

This is not, however, a decisive argument against the proposal. There is now overwhelming evidence that the level of reported bank profits is not a critical determinant of the stock market valuation of bank shares. The stock market saw through the attempt of the banks (encouraged by officials) to pretend that the value of their sovereign loans had been unimpaired by the debt crisis. The market can perhaps be expected to value the increase in bank claims resulting from capitalization about as highly (or lowly) as that resulting from involuntary lending, even if the accountants continue to insist that the former process does not generate income that can be accrued into profits and the latter does. Furthermore, banks that wished to preserve the legal fiction that interest was not being capitalized could be allowed to place an equivalent amount of "new money" in an escrow account from which a part of their interest payments would be drawn. A procedure like this was employed in the Polish restructuring in 1981.

It is less likely that a definitive debt reconstruction would be classified as a "troubled debt restructuring" (which occurs when the accountants judge that a restructuring involves a "concession") than it would have been if such changes had been made piecemeal in a series of emergency responses to the debt crisis. One can indeed argue that automatic interest capitalization in excess of a formula related to export earnings would have provided a more logical basis for medium-term sovereign loans than the floating interest rates that were incorporated in past loans.

Finally, it is the regulators rather than the accountants who decide whether loans have to be classified as "value-impaired," which carries the penalty of having to reserve a specified percentage against the loans involved. In making such decisions, the regulators need to consider the health of the banking system. Once they concluded that innovations in bank practice presented the best chance of preserving the present value of bank claims, it would be counterproductive to classify loans that implemented those innovations as value-impaired.

None of this is to suggest that the accountants, the bankers, or the stock market would be likely to welcome the capitalization of interest in excess of a ceiling based on the value of exports. What it does suggest is that their anguish would be no greater than that of the banks that decide to sacrifice present value and grant debt relief, or of the debtors. No one is likely to be particularly happy with a definitive debt reconstruction, which of necessity involves definitive recognition of past mistakes. The question is whether a better alternative exists.

Another possible objection to definitive debt reconstruction is that it might weaken the pressures for policy reform by the debtors. The requirement of negotiating new money packages gives the banks leverage to insist that the debtor implement what they perceive to be appropriate policies. The banks generally exercise this leverage by requiring that the debtor negotiate a high-conditionality program with the IMF. Once debt-service obligations had been cut back to a level that the country could handle, it would lose this close foreign monitoring of its economy.

This might be a strong objection if there were convincing evidence that

effective conditionality programs could be designed and monitored over lengthy periods. In fact, however, the evidence seems distinctly discouraging (see Sachs 1988 for a recent appraisal). Indeed, the Fund itself has never exhibited much confidence in its ability to design and monitor medium-run (let alone long-run) programs. It seems sensible enough to require that the banks be satisfied with the thrust of policy at the time when the definitive debt reconstruction is negotiated, and the best mechanisms available for judging the adequacy of policy remain IMF conditionality and World Bank structural adjustment lending. It was also suggested above that the Bank might make access to exit bonds conditional upon prudent fiscal and exchange rate policies. But the purpose of a definitive debt reconstruction is to permit a return to normality, and endless high-conditionality IMF programs are not, and should not be considered, normal for any country.

A standard argument against capping interest payments and interest capitalization has been that debtor countries would prejudice their own futures if they participated, by jeopardizing their future access to bank lending. Unfortunately, the debt crisis has already lingered so long that this argument has lost much of its force: most debtor countries already seem condemned to at best limited access to the international capital market for some years.

It has even been counterargued that historical experience shows little evidence of countries suffering future loss of access to credit markets as a result of default; on the contrary, a reduction in outstanding debt is asserted to create favorable conditions for a resumption of lending (Kaletsky 1985; Jorgensen and Sachs 1988). However convincing the evidence from the past, it would be rash to extrapolate this sort of empirical regularity into the future.

The most prudent course would seem to be one that avoids both unlimited current sacrifices in the hope of restoring access to bank credit and casual disregard of the interests of creditors. One has to doubt whether a debt reconstruction that avoids prejudicing lenders relative to what they can currently expect, and that permits debtors to recover faster than currently seems likely, can really be bad for the debtors' future creditworthiness.

Another possible argument against automatic capitalization in excess of a cap determined by export earnings is that under particularly adverse circumstances—namely a long period of unexpectedly low export earnings—a country's total external debt could compound to an unmanageably large sum. However, it is important to remember that this proposal is being advanced in conjunction with the facilitation of buybacks. As a country's debt mounted,

its price on the secondary market would decline. The debtor would be entitled to use some if its export earnings to buy back debt at this low price, thereby tending to offset the increase in debt resulting from interest capitalization. Thus even in this worst-case scenario, the two proposals together (formula-determined interest capitalization and buybacks) would lead to a self-equilibrating system, which is surely an advantage over present arrangements.

The definitive debt reconstruction envisaged here would need to be negotiated in the same way as the many reschedulings already agreed, with discussions between the authorities of each individual debtor country and the Bank Advisory Committee, followed by acceptance of the terms by each of the country's commercial bank creditors that did not choose to exit. The new loans could presumably carry standard interest rates. They would be of indeterminate duration, specifying a rate of amortization following any grace period. They would also provide for a rollover of principal as well as capitalization of interest whenever debt-service charges exceeded payments due as calculated by the formula related to the level of export receipts. The parties would have to agree on a mechanism for verifying the value of exports to be used in the formula. Clearly these proposals involve some substantial innovations in current banking practices, even though they are intended to do no more than formalize what actually happens now. The legitimate interest of the banks would be to ensure that the new arrangements did not leave them worse off than they could have expected to be under current practices.

The principal problem, as always in rescheduling, would be to deal with the fringe of banks not prepared to accept these terms. The best solution would be to let them hold on to their existing loans (and keep open the option of conversion to the new terms) indefinitely, while cutting back interest payments to the level that would have applied had they accepted the offer of conversion. The banks involved would then presumably accumulate arrears, which would have the same result as the interest capitalization involved in the new terms. The nonconverting banks would be unable to use the sharing clause to sue the banks that did convert since the payments made to both groups of banks would be proportionate. Hence the only legal redress of the nonconverting banks would be to sue the debtor and seek to seize its assets—the doomsday weapon that the banks have always shrunk from using up to now. It hardly seems likely that a fringe bank would incur the legal costs, the risks, and the odium of wielding the doomsday weapon when the option of exit was simultaneously being facilitated.

6 *The Potential of Voluntary Debt Relief*

It is increasingly widely accepted that resolution of the debt crisis will require a measure of debt relief. Indeed, the Toronto Summit in June 1988 approved a framework agreement for the provision of relief on official debt to the poorest heavily indebted countries, primarily in sub-Saharan Africa. Although the summit leaders did not bring themselves to endorse any comparable initiative for the middle-income debtors or commercial bank loans, their endorsement of "innovative financing techniques . . . that . . . are voluntary, market oriented and applied on a case by case basis" (Summit Communiqué, paragraph 27) suggests their openness to much of the approach developed in this study.

Some economists argue that the middle-income debtors are already getting substantial debt relief. For example, Bulow and Rogoff (1988) treat new money agreements as partial default rather than postponement of interest. Their premise is that the debt is too large for there to be a significant chance that it will ever be fully serviced without new money, and that creditors and debtors are engaged in essentially continuous and permanent negotiations as to what fraction of their obligations the debtors can afford to pay. This view implies that any repurchase of marginal debt is of minimal significance or benefit to the debtor: since it has to be repurchased at a price that reflects the average expected interest payments, the cost of repurchase exceeds the benefit. The policy conclusion is that the debtors are already getting debt relief and should learn to appreciate their good fortune.

The view underlying the present study is quite different. I accept that many bank creditors, holding perhaps as much as one-third of LDC debt, share the pessimistic Bulow–Rogoff view (or are prepared to act as though they did for various institutional reasons, which may include a belief that their stockholders share that view). But I believe that view is wrong (for reasons laid out most fully by Cohen 1985). If they find the short and medium run tolerable, debtors will be capable of servicing their debt fully in the long run. One way of making the medium run shorter, and thus more tolerable, is to exploit the pessimistic creditors who share the Bulow–Rogoff view, which one can do either by buying back their debt or selling them guaranteed exit bonds at prices that reflect their pessimistic expectations. Since given their expectations they will feel it is they that are doing the exploiting, everyone will be happy, or at least less unhappy.

Hence the first step is to facilitate buybacks, by having the banks periodically agree to waive the sharing clause. Such a gesture would not amount to much unless countries have some source of cash with which they can finance buybacks when they judge purchase worthwhile. It was suggested in section 4 that this might be accomplished by agreeing that certain revenue streams would be disregarded when the banks negotiate new money packages. The next step is to have the World Bank inaugurate an immediate program to guarantee exit bonds issued by debtor countries whose policies merit confidence that the guarantees will not be called.

How much could voluntary debt relief accomplish? The data and calculations in the tables are intended to give a rough answer. Table 1 shows certain cash flows for the 17 highly indebted middle-income countries from 1983 to 1988. The figures for 1988 are not actual outcomes or even forecasts of probable outcomes, but rather estimates of plausible "trend" values for 1988. (It is likely, for example, that exports will in the event exceed $150 billion, owing to strong prices of many primary commodities.) The figure for new lending by banks is that implied by the Baker Plan.[24]

TABLE 1 **Cash flows of the 17 highly indebted countries, 1983–88**
(billion dollars)

	1983	*1984*	*1985*	*1986*	*1987*	*1988*[a]
Exports of goods and services	138.1	153.7	149.1	132.3	n.a.	150
Interest payments	29.6	34.2	33.6	31.1	32.8	34.0
on long term public debt to banks	17.4	19.2	20.9	18.8	19.3	20.1
other (official, private, IMF,[b] suppliers)	12.2	15.0	12.7	12.3	13.5	13.9
Capital inflows	19.2	10.9	10.0	5.2	n.a.	11.8
from banks, "new money"	13.1	4.6	6.5	0.3	10.3	6.6
other loans	6.1	6.3	3.5	4.9	n.a.	5.2
Negative resource transfer (implied)	10.4	23.3	23.6	25.9	n.a.	22.2
Negative resource transfer (actual)	7.5	17.5	26.1	24.8	20.0	n.a.
Memorandum item: direct investment	3.4	3.2	4.5	2.9	n.a.	3.5

Sources: World Debt Tables, 1987–88 edition, vol. 1, pp. 30–33 and Table 2, p. xiii for actual resource transfer. *International Financial Statistics* for direct investment. Institute of International Finance for new bank lending.
n.a. = not available
a. Data for 1988 are plausible trend values.
b. Estimated.

TABLE 2 **Resource transfer under alternative scenarios**

	"1990"		"2000"	
	Billion dollars	*Percentage of exports of goods & services*	*Billion dollars*	*Percentage of exports of goods & services*
No debt relief				
Constant debt	−33.9	20.5	−33.0	12.2
Baker Plan	−23.9	14.5	−32.1	11.9
Buybacks				
Constant debt	−30.6	18.5	−33.0	12.2
Same borrowing as Baker Plan	−26.8	16.2	−25.4	9.4
Exit bonds				
Constant debt	−27.4	16.6	−33.0	12.2
Same borrowing as Baker Plan	−23.9	14.5	−25.4	9.4

Source: Table 1.

The figures for the implied negative resource transfers in table 1 are interest payments *less* borrowing. The main inadequacy of these figures is that they exclude both profit remittances and inflows of direct investment (shown as a memorandum item), but the two tend to cancel. A comparison of the implied transfers and the World Bank's estimates of actual transfers (shown in the following row) indicates that the discrepancies are not so large as to preclude the use of the statistics in the table for projecting resource transfers.

The data in table 1 are used to construct the estimates of negative resource transfers under various scenarios shown in table 2. The year "1990" represents a year when buybacks are in progress or exit bonds are being serviced, while the year "2000" represents a year when cash flows are benefiting from the completion of buybacks or the payoff of exit bonds. The table compares negative resource transfers in each "year" without debt relief in the first panel, and with buybacks and exit bonds in the other two panels. In each of these three cases, the table shows the outcome with two alternative assumptions about the future path of debt: that it is held constant after 1988, and that the country borrows henceforth at the rate provided for by the Baker Plan. This is interpreted as constant annual lending of $6.6 billion by the banks and $5.2 billion by all other lenders. (This results in total debt increasing from an estimated $489 billion in 1988 to $630 billion in 2000, without debt relief.)

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[24] New money packages agreed with the 17 highly indebted countries in 1986–87 summed to $10.6 billion, somewhat less than the $13.2 billion target increase proposed in the Baker Plan.

The other principal assumptions incorporated in the calculations are:

- that the estimated 1987 interest rates of 7.7 percent on bank debt and 6.1 percent on other loans remain constant at those levels
- that one-third of bank debt could be bought back for an average discount of 50 percent either through buybacks or through exit bonds[25]
- that exit bonds have a maturity of 9.4 years and a coupon of 7.7 per year (and therefore have a present value of 50 percent when discounting at the banks' interest rate), and are all issued in 1989
- that buybacks would occur at a constant rate over the same 9.4 years that exit bonds would be serviced
- that after 1988 exports grow at a constant rate of 5 percent per year. (If one assumes that smaller negative resource transfers in early years were partially devoted to investment in export production, exports would be larger and therefore the ratio of resource transfers to exports smaller in 2000 in the cases where borrowing proceeds according to the Baker Plan.)

Inspection of table 2 suggests a number of conclusions. The first is that a major erosion in the negative resource transfer as a percentage of exports (to a level below that currently implied by the Baker Plan) ultimately can be expected even without debt relief, overwhelmingly as a result of the growth

in exports. It remains true that the best cure for the debt crisis is to grow out of it. It is true that export values failed to grow after 1982 (table 1): the rise in export volumes was offset by weak export prices, especially for primary products. But this unhappy state of affairs should not last indefinitely. As long as investment in export industries is not cut back too severely (as could conceivably happen if the negative resource transfer became excessive), exports can be expected to grow again sooner or later and ease the debt problem even without debt relief.

A second conclusion is that, unless one believes the Baker Plan was wrong to reduce the negative resource transfer, a policy of attempting to prevent any further buildup in debt would be ill-conceived. That remains true even in the presence of debt relief on the scale envisaged here, at least until buybacks are complete or exit bonds are paid off, i.e., until the late 1990s. Despite their current difficulties, these countries are natural capital importers, and the aim of policy should be to increase rather than curtail the capital that flows to them, even at the cost of a further buildup in debt.

Third, it is apparent that the benefits of a buyback program would be positive but quite modest. With a constant long-run level of debt (by assumption), the benefits all accrue in the short run: buybacks on the scale hypothesized would reduce the cost of stabilizing the debt by a little more than $3 billion per year. Under a policy of continuing to borrow on the scale of the Baker Plan, the long-run benefit of buybacks would be quite substantial (a reduction of almost 3 percent in the negative resource transfer as a fraction of exports). But in the short run, buybacks cost cash, and therefore the negative resource transfer as a fraction of exports is almost 3 percent larger than under the Baker Plan. Given the presumption that the foreign exchange shortage should ease over time, this suggests that buybacks might best be used as a way of making profitable use of unexpected foreign-exchange windfalls.

Fourth, it can be seen that exit bonds dominate buybacks. Under a constant-debt objective they lead to the same long-run outcome as the other two strategies (that equality is inherent in maintaining debt constant), but the short-run cost is lower. In particular, exit bonds dominate buybacks in the short run because the entire one-third of the debt that is by assumption being bought back at 50 percent is dealt with up front,[26] whereas under the

alternative strategy the country continues to pay full interest on loans that will ultimately be bought back until it can afford the buyback. This advantage is additional to the greater chance of being able to secure a favorable discount for a large volume of debt through the auction of exit bonds as opposed to relying on buybacks (see note 25).

The exit bonds used in this illustration were designed to achieve the same negative resource transfer in the short run as the Baker Plan. Even to accomplish this, the nonexiting banks will have to be prepared to increase their new lending by 50 percent, from 2.5 percent to 3.75 percent of exposure each year, to compensate for the banks that exit. If that is judged impractical within the process of assembling new money packages, or if it is concluded that the negative resource transfer implied by the Baker Plan is unacceptably large and that the banks should play a role in reducing it, then it might be necessary to supplement voluntary debt relief with a reconstruction of the debt of the nonexiting banks. It was suggested in section 5 that such a reconstruction might provide for automatic rollover of principal and capitalization of interest when debt-service charges exceed a cap based on export earnings.

These figures make it clear that voluntary debt relief is no panacea. If the debt crisis evaporates quickly and painlessly in the next five years, it will be because the value of debtor-country exports surges as the higher recent primary product prices stabilize, or because interest rates halve again without a deterioration in the debtors' terms of trade. If a new upsurge in interest rates causes a new recession, then voluntary debt relief is not likely to counter the damage. But it could nonetheless play a useful role in intermediate scenarios in which world growth is maintained in the range of 2 percent or 3 percent per year with no decisive changes in interest rates and some relapse in the terms of trade. It could also have some psychological importance in reassuring debtors that the costs of past overborrowing (equals overlending) are being shared. And it would offer assurance that their longer-run position will improve even if export performance continues to be disappointing.

7 *Conclusion*

An end to the debt crisis implies two things. The first is an easing of the foreign exchange constraint that has throttled growth in the debtor countries since 1982. The second is an end to the repeated need to negotiate external financial support in a crisis atmosphere.

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[25] It is more reasonable to assume that such a large volume of exit bonds might be issued at close to the present secondary market price than that an equivalent value of buybacks could be achieved at such a low price, since the price on the secondary market would rise as debt declined while the banks would be required to bid for exit bonds at a time when the debtor's prospects were still clouded. However, the assumption that voluntary debt relief would take place on similar terms under either mechanism is needed to permit a clean comparison.

[26] In practice this might be over three or four years, but this would still lead to a quicker realization of the interest savings than would be possible under buybacks.

Voluntary debt relief alone could probably achieve both eventually, but the import of table 2 is that the process could be lengthy. A more rapid solution requires the provision of routine liquidity relief according to need. This would seem to demand either substantially larger lending by the multilateral development banks, one of the comprehensive schemes for debt relief whose practicality was questioned in section 2, or else a combination of voluntary debt relief with the cap plus capitalization proposal developed at the end of section 5. My own preference is for the latter solution.

The virtue of the Baker Plan is its elasticity, which has already proved sufficient to embrace the menu approach. The proposals developed in this study seek to carry this process of evolutionary change a stage further. They seek not so much to lengthen the menu as to provide a greater contrast in the entrées that will induce each bank to make a clear decision as to whether its contribution will take the form of debt relief or liquidity relief. They envisage a bold but temporary use of the World Bank's guarantee powers as the public sector's contribution to presenting the banks with a sharp choice concerning the form in which each will contribute. To the debtor countries they offer both assurance of light at the end of the tunnel and the hope of a shorter tunnel.

AMERICA IN THE WORLD ECONOMY
by C.FRED BERGSTEN

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7

Third World Debt and Burden Sharing: Mobilizing the International Financial Institutions

A third major cluster of international economic challenges facing the new administration and Congress can best be addressed by substantially enhancing the role of the international financial institutions (IFIs). Three such challenges are of greatest importance: Third World debt, burden sharing, and the possible reentry of the Soviet Union into world economic affairs. Two other considerations strongly support a renewed American commitment to these organizations: budget constraints on spending for international economic purposes, and the need to forge a new leadership role for the United States within the pluralistic power structure of the contemporary world economy. The institutional focus of this discussion will be the World Bank, the IMF, and, to a lesser extent, the Inter-American Development Bank (IDB).

THIRD WORLD DEBT

The most important of these issues is Third World debt. A much more effective response to this problem must be an integral part of the proposed strategy for several reasons.

First, a revival of Third World markets, especially in Latin America, can make an important contribution to the necessary US trade correction. US exports to Latin America declined by almost $20 billion from 1981 to 1983, because of the sharp decline in the import capability of the region, and they still have not climbed back to their earlier level; the region's total imports remain $30 billion below their previous peak. The Baker 15 highly indebted nations must now generate trade surpluses of about $30 billion annually to service their debts, given the sharp decline in new capital flows to them.[1] If they could reverse or even substantially reduce this "negative financial transfer," they could restore faster economic growth and increase their imports. A relaxation of the debt constraint would also enable these countries to carry out faster and more extensive liberalization of their import controls, thereby enhancing US adjustment prospects.

Second, a more effective response to Third World debt is needed to prevent instability in the US and global banking systems. American banks have substantially strengthened their capital positions since the debt crisis erupted in 1982, and they have considerably reduced their exposure to debtor countries as well (see table 7.1). Nevertheless, some major money center banks remain at risk.

No single debtor country, even Brazil or Mexico, could now cause a major financial crisis in the United-States, even with a total default. But simultaneous defaults by the three largest debtors (Argentina, Brazil, Mexico), let alone Latin America as a whole or the entire group of major debtors, could still cause enormous disruption. The US financial system has already been jeopardized by the crisis in the savings and loan industry, and by continuing bank problems in some regions. This further highlights the importance of avoiding shocks from abroad.

There are two (perhaps related) situations under which Third World debt could trigger major financial disruption. One would be a simultaneous resort to radical policies in the key debtor countries, despite the admitted failures of such strategies undertaken to date (such as Alain Garcia's 1986 ceiling on debt service payments in Peru, or Brazil's repayment moratorium in 1987). The other would be if the world economy sank into recession, shrinking export markets for the debtors and thus further limiting their access to foreign exchange. If the recession were caused by a sharp rise in real interest rates, as occurred in 1982, the double blow to the debtors could tip many of them into default. We have argued throughout this volume that a recession with high interest rates is possible if the United States and the other industrial countries fail to take decisive action to resolve the huge imbalances among them. The possible reigniting of the Third World crisis thus supplies yet another reason for those nations to take such action, but the risk of such an outcome also counsels more effective steps on Third World debt itself.

Successful implementation of the strategy proposed in this volume would provide substantial help to the debtor countries of the Third World. Faster world growth would enhance their export opportunities. Renewed liberalization of trade, especially if it included a phase-out of controls on textiles and other products exported by LDCs, would have a similar effect. Most directly, the reduction of dollar (and perhaps world) interest rates that should result from a decisive reduction in the US budget deficit would substantially reduce the costs of debt service. Every drop of one percentage point in market interest rates saves the debtors about $5 billion annually, and, according to the WEFA model of the US economy, a decline of a full percentage point or more should be possible if the proposed adjustment strategy is followed.

The third reason the Third World debt problem must be handled better, by far most important to the debtor countries themselves, is to restore their economic growth. The 1980s have been a lost decade for most of these countries, with per capita incomes lower now than a decade (or, in some cases, even two decades) ago.[2] The encouraging democratization of countries throughout Latin America, and in the Philippines as well, could be jeopardized if growth is not restored soon.

Third World debt can be stabilized over the long run only with better policies in the debtor countries, a sharp and sustained increase in the availability of external resources, and a new leadership structure

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[1] Over 80 percent of the trade surpluses and debt-service costs of the Baker 15 are located in Latin America.

[2] The World Bank estimates that per capita consumption declined 1.6 percent annually from 1980–1987 for the 17 heavily indebted countries (the Baker 15 plus Costa Rica and Jamaica). (World Bank 1988, xiv, and Balassa, et al. 1986, 52–53).

TABLE 7.1 Exposure of US Banks in Developing Countries and Eastern Europe
(end of calendar years)

	Amount owed to US banks				Ratio of exposure to capital			
	1982	1985	1986	1987	1982	1985	1986	1987
	(million dollars)				*(percent)*			
All Banks								
Baker 15[a]	91,085	90,526	86,172	81,695	129.0	85.9	74.2	63.2
Argentina	8,231	8,411	8,524	8,812	11.7	8.0	7.3	6.8
Brazil	20,438	22,796	22,404	21,275	28.9	21.6	19.3	16.5
Mexico	24,377	24,934	23,654	22,722	34.5	23.7	20.4	17.6
Non-OPEC LDCs	103,180	98,186	90,492	84,761	146.1	93.2	77.9	65.6
Eastern Europe	6,278	4,358	3,571	3,239	8.9	4.1	3.1	2.5
Sum	109,458	102,543	94,063	88,000	155.0	97.3	81.0	68.1
9 Largest Banks[b]								
Baker 15[a]	55,868	58,851	56,383	54,566	192.6	139.1	120.7	106.0
Argentina	5,125	5,875	5,927	6,295	17.7	13.9	12.7	12.2
Brazil	13,296	15,550	15,358	15,007	45.8	36.8	32.9	29.1
Mexico	12,862	14,087	13,353	13,351	44.4	33.3	28.6	25.9
Non-OPEC LDCs	64,148	62,801	58,308	55,762	221.2	148.5	124.9	108.3
Eastern Europe	4,045	2,931	2,354	2,271	13.9	6.9	5.0	4.4
Sum	68,193	65,732	60,662	58,033	235.1	155.4	129.9	112.7

Source: Board of Governors of the Federal Reserve System, "Country Exposure Lending Survey," Statistical Release no. E.16, Washington, various issues.

a. The Baker 15, so named because they are the countries targeted in the Baker Plan for dealing with the debt crisis, are Argentina, Brazil, Mexico, Bolivia, Chile, Colombia, Ecuador, Ivory Coast, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

b. Bank of America, Citibank, Chase Manhattan, Manufacturers Hanover, Morgan Guaranty, Chemical, Continental Illinois, Bankers Trust, and the First National Bank of Chicago.

for the handling of the problem. The Baker Plan has encouraged most of the debtor countries to begin adopting necessary reforms, but most of them still have a long way to go. The commercial banks and other external lenders, while responding to new adjustment programs in the largest countries, have failed to provide adequate resources to support the strategy; negative financial transfers from the Baker 15 have totaled about $30 billion during each of the past two years. Voluntary debt relief schemes have begun to help a few countries (such as Bolivia and Mexico), but to date they have been modest in scope.

The core of any strategy for dealing with each of these three components of the debt problem must be a sharp expansion in the role of the IFIs. Because of their multilateral status and proven expertise, these institutions are in the best position by far to encourage the debtor countries to pursue effective policies to deal with inflation, their underlying fiscal imbalances, and structural problems like excessive governmental regulation and state ownership of enterprises, all of which hamper their adjustment.[5] But the ability of the IFIs to persuade the debtors to change their policies has been limited by the modest level of resources that they have been able to offer as inducements. Indeed, the three major international financial institutions—the IMF, the World Bank, and the IDB—are now "contributing" to the negative financial transfer: over the past year, each of them withdrew about $1 billion from the Baker 15.

This negative flow resulted in part from a slowdown in the disbursement of funds already committed as a result of project cutbacks in the debtor countries, a consequence of debtor efforts to reduce their budget deficits. Some of the slowdown quite properly reflected the absence of effective economic policies or projects worthy of support. Some also results from the accounting treatment of the recent changes in the value of the dollar, the currency in which the World Bank and the IDB keep their accounts.

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[5] Brazil publicly admitted in early 1988 that external debt was not its main problem when recognizing that its moratorium of 1987 had been a costly failure. The details of the policy changes required for adjustment in Latin America can be found in Balassa, et al. (1986, 13–15, 23–32).

Nevertheless, there has been a sharp diminution of the contribution of these institutions at a time when a significant rise in their support is needed instead. Increased lending can induce better policies in recipient countries by easing the costs of those policies (for example, the increased foreign exchange expenditures that result from import liberalization) and by providing tangible rewards for the implementation of such policies, which strengthens the position of the officials who pursue them. A significant expansion of the role of the IFIs offers the best prospect for achieving the major policy reforms required in the debtor countries.

The IFIs also provide the only real hope for achieving substantial increases in new lending to the debtor countries. The multilateral development banks, as intermediaries in the world's capital markets, can borrow substantially larger amounts for lending to the debtor countries than private investors would be willing to transfer on their own. This is partly because these institutions can attach policy conditions to their credits, maximizing the chances that new funds will be used productively. But it is also because the development banks' own bonds are backed by their member governments, which include the industrial countries. The World Bank and the IDB obviously should not increase their lending (and borrowing) so much that they jeopardize their own credibility and credit ratings, but it seems quite feasible for them to expand substantially the size of their commitments and the pace of their disbursements.

At least $20 billion of additional new lending to the major debtors is needed each year for the foreseeable future (Balassa, et al. 1986, 40; Lessard and Williamson 1985, 27–28). The commercial banks may still be dragooned by the authorities into "involuntary lending" through new money packages for a few major borrowers, but it is clear that they are reducing rather than expanding their exposure (see table 7.1). Very little flight capital is likely to be repatriated soon—although the debtor countries must make every effort to attract it—and the adoption of better domestic policies is the only practical way to do so over the long run (Lessard and Williamson 1987). Direct investment and nonbank financial lending also have considerable potential over the long run and are quite responsive to changes in host country policies; they can make a modest contribution now, but will not occur on a major scale until the debt problem itself appears much closer to a lasting resolution.[4] Export credit agencies in industrial countries should expand their programs, as recommended for the United States in Chapter 6, but governments in those countries are not likely to provide much direct assistance because of their budget problems. Hence the IFIs, backed by their wealthiest member countries, are the only viable source of significant flows of new money to debtor countries.

Debt relief is an additional possibility. It is now clear that a number of the poorest countries, particularly in Africa, have little prospect of fully servicing their debt—let alone repaying it—and that they will require extensive debt relief. Most of the credits to these countries have been issued or guaranteed by governments in the industrial world, rather than by commercial banks or other private lenders, so many of the complications involved in providing relief from private credits are not relevant. The largest industrial countries agreed at the Toronto Summit in June 1988 to step up these efforts. Working primarily through the Paris Club, they now need to do so as expeditiously as possible.

The issue of relief for the large debtors in Latin America is much more complex, however, both because of the greater magnitudes involved and because most of the debt is owed to commercial banks. Such relief can come from only two sources: the public purse and the lenders themselves. However, the potential role of governments in the industrial countries (including the United States) is severely limited by budget constraints and the need to provide relief for the poorest countries—the priority recipients of such concessional assistance according to traditional aid criteria.

As for the private lenders, there is no way to require them to participate. Sweeping relief schemes that propose creating new international institutions to buy current debt at a discount and pass

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[4] Detailed proposals for expanding such flows can be found in Lessard and Williamson (1985). For example, host-country liberalization of restrictions on foreign direct investment could encourage substantial increases in this type of transfer—which is particularly appealing in the debt context because it is "serviced" only when the investment itself is profitable. Liberalization of host-country rules governing foreign access to domestic equity markets can also trigger significant inflows as shown recently in Brazil, India, Thailand, and others (Hale 1988, 24). In addition, country-specific mutual funds have considerable promise; the Brazil Fund was successfully launched in March 1988 and attracted $150 million (International Finance Corporation, Capital Markets Department, Emerging Markets Data Base).

on the benefits to debtor countries in return for new policy commitments are therefore almost certainly infeasible. Any truly comprehensive relief scheme, covering all lenders and all countries in one fell swoop, would also reduce the pressure to adopt better economic policies and could leave the debtor countries worse off once the short-term benefit of the relief itself had passed.[5]

The most promising approach is therefore to try to induce the private banks to offer relief on a voluntary basis. Most of the banks are now able to do so, at least to some extent, because they have strengthened their capital positions considerably and have set aside substantial reserves against their loans to the Third World—in the range of 25–30 percent of exposure for the money center banks, and 50 percent or more for the regional (and most foreign) banks. Actual write-offs of credits up to the levels reserved would eliminate any prospect of returning those reserves to reported earnings in the future, but would not generate additional losses on the income statement because the reserves themselves were deducted from current income reported to shareholders when they were set aside. Write-offs would, of course, reduce bank capital by a corresponding amount, although, as losses are actually realized, such write-offs can be deducted from income assessed for tax purposes. The losses are thus shared by the Treasury.

Some banks have already indicated a willingness to provide modest relief by selling loans back to debtor countries at a discount or by buying discounted exit bonds that exempt them from any future "obligation" to participate in new-money packages. It is likely that a number of banks would go further down this road if the inducement to do so were greater, and negotiations between creditors and debtors on the price that will provide such an inducement are now under way for some countries.

The IFIs should attempt to accelerate this process by offering guarantees of new debt instruments that would confer meaningful relief. A specific scheme for that purpose is developed in the section below on the World Bank. The governments of the industrial countries could also make changes in regulatory, accounting, and perhaps tax practices that would encourage the banks to offer additional relief. Banks that do not wish to exit the process through discounted bonds should be pressed hard to provide a proportional share of new-money packages that support policy reforms ratified by the IFIs—perhaps through interest capitalization, which provides cash flow relief if no actual reduction in the debt itself.

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[5] For examples of broad relief schemes, see Peter Kenen in the *New York Times*, 6 March 1983, Felix Rohatyn in *Business Week*, 28 February 1983, and the recent proposal by James Robinson of American Express (1988). The proponents of these approaches generally argue that they could be carried out on a case-by-case basis, and insist on sound adjustment policies, but it is hard to see how relief could be denied to all or most countries once granted to any major debtor.

The objective of these several elements of a new debt strategy is to eliminate or begin to reverse the $30 billion annual "negative financial transfer" from the Baker 15 by the end of the four-year adjustment period in 1992. About $15–20 billion could come from increased lending by the IFIs, $5–10 billion from the lower interest rates resulting from industrial country adjustment, and the rest from voluntary debt relief and new flows of capital from private sources and export credit agencies (see table 1.1). Such an outcome would permit at least a modest increase in growth in the debtor countries, further reduce the risk of global financial instability, and make an important contribution to the international adjustment process. If better policies and performance in the debtor countries were to justify even larger increases in the flow of new capital and the reduction of existing debt, the United States and the other industrial countries—working mainly through the IFIs—should make every effort to provide such assistance.

The IFIs, particularly the World Bank, in view of the long-term nature of the debt problem, also must be given a much stronger leadership role in managing the issue. The IMF, quite properly (and effectively), took the lead role in the first phase, when the problem appeared to be a short-term one and had to be dealt with in crisis terms in any event. But the early rationale for Fund leadership has now disappeared, and the revolving nature of Fund loans limits its potential for financing longer-term adjustment. Furthermore, the Fund's essential role in the international monetary system—a role that needs to be substantially enhanced, as described below—demands that it limit the riskiness of its own portfolio and hence reduces its ability to lead the next phase of the debt strategy. The Fund's imprimatur will continue to be of critical importance to private lenders. But its constitutionally defined short-term focus and its image as a purveyor of austerity—however unfair, since Fund-related financing tends to reduce the degree of austerity needed to extricate countries from their largely self-imposed straits—make it quite difficult for the Fund to lead a successful growth-oriented debt strategy.

No single country can provide effective leadership for such a global problem. Strong US support will be needed for any lasting solution, but US interests would probably be served by a less aggressive role than was characteristic of the Baker Plan. Such a prominent role reinforces the view of some lenders in other countries that Third World debt "is an American problem" and that the United States should provide most of the new money and necessary policy concessions, despite the fact that only one-third of the bank debt is owed to American institutions.

A clearly designated leader is badly needed, however, to forge agreements among the debtor countries, private lenders, governments of the creditor countries, and the several IFIs themselves. The World Bank could naturally accede to this role by sharply expanding its own lending activities and sponsoring policy initiatives to facilitate voluntary debt relief. Proposals to that end will be offered below.

The United States would benefit, in particular, from a significant easing of the debt problem in Mexico. The United States has numerous interests in a speedy and substantial revival of the Mexican economy: a reduction in the incentive for Mexicans to migrate north; Mexico's pivotal role in the financial problems of a number of American banks; its market potential as America's third-largest trading partner; and a stable resolution of the political uncertainties following its latest national elections. It is difficult, however, for the United States to provide substantial bilateral assistance to Mexico, given the hostility engendered by a donor-client relationship on both sides of the border (as well as the usual budget constraints). For many years, Mexico has been one of the largest recipients of funding from all three of the main IFIs. A further substantial increase in their engagement with Mexico, aimed both at supporting additional policy reforms and expanding the inward flow of resources, would be of particular interest to the United States.

IMPROVED BURDEN SHARING

The second major issue that can best be addressed through the IFIs is the development of a better distribution of the costs of maintaining global security, including the prosperity and stability of the world economy. Efforts to devise a precise formula for "fair shares" are conceptually difficult, and would take an inordinate amount of time to negotiate. The United States spends a considerably higher proportion of its GNP on defense and foreign assistance than do its allies,[6] however, and will probably need to level off, or even cut, its military expenditures as part of the effort to eliminate the budget deficit by FY 1993 as called for by Gramm-Rudman-Hollings (and this book). There is thus a strong case for increased contributions from Europe and especially Japan (table 7.2).

There is widespread agreement that it would be a mistake to permit this problem to disrupt alliance security arrangements, especially given the potentially historic opportunities for greater stability now presented by the new leadership in the Soviet Union. Moreover, the United States has considered the defense of Europe and Japan to be an integral element in its own security throughout the postwar period, and there is no reason to alter that belief now. There is also widespread agreement that it would be a mistake for Japan to undertake a massive rearmament effort and enlarge its military role in Asia.

There is also wide agreement, however, that there have been sharp changes in relative economic capabilities in the period since the present security structure was put in place in the 1950s. The rapid progress of other countries and the associated relative decline of the United States during the past three decades, described in Chapter 3, now require some revision of national contributions to international security, broadly defined to include its economic component. Such a revision should be accomplished through a shift in relative financial obligations, rather than through any major restructuring of the security arrangements themselves.

In this context, most of the allies agree that some of them—obviously Japan, but perhaps some Europeans as well—should be doing more to support international public goods such as foreign assistance and debt relief. Just as the United States did when it was the dominant surplus country during the Marshall Plan period, Japan

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[6] It should be noted, however, that the United States ranks next-to-last among all OECD countries in shares of GNP devoted to concessional aid alone ("official development assistance," or ODA).

TABLE 7.2 Defense and Economic Assistance Expenditures in the Western Alliance, 1986 *(percentage of GDP)*

Country	Defense expenditures	Economic assistance	Combined expenditures	Index of effort (US = 100)
United States	6.7	0.2	6.9	100
NATO Allies				
Belgium	3.0	0.5	3.4	50
Canada	2.2	0.5	2.6	38
Denmark	2.0	0.8	2.9	41
France	3.9	0.7	4.6	67
Germany	3.1	0.4	3.5	51
Greece	6.1	0.0	6.1	88
Italy	2.2	0.4	2.6	38
Luxembourg	0.9	0.0	0.9	14
Netherlands	3.0	1.0	4.0	58
Norway	3.1	1.1	4.3	62
Portugal	3.2	0.0	3.2	47
Spain[a]	2.0	0.0	2.0	28
Turkey	4.8	0.0	4.8	69
United Kingdom	5.0	0.3	5.3	77
Non-US NATO Weighted Avg.[b]	3.3	0.5	3.7	54
Japan[a]	1.0	0.3	1.3	19

Note: Detail may not add to totals because of rounding.

Sources: Congressional Budget Office computations using data from NATO Press Service, "Financial and Economic Data Related to NATO Defense" (December 1987) for defense expenditures; data for gross domestic product from International Monetary Fund, *International Financial Statistics* (January 1988); and from Organization for Economic Cooperation and Development, *Development Assistance* (December 1987), for economic assistance.

a. Defense expenditures for Spain and Japan use the national, not NATO, definition as reported in International Institute for Strategic Studies, *The Military Balance 1987–1988* (London: IISS, 1987).

b. Using 1986 gross domestic product shares.

should "reverse tie" its aid—that is, prohibit it from being used in Japan. Europe and Japan will only do more, however, if they receive full credit for their new capabilities and contributions, just as the United States will want to retain predominant control of allied security arrangements because of its superior contributions in that sphere. Deals of this kind can best be worked out and implemented in the IFIs.

An alternative is to address the burden-sharing issue in the defense context, linking economics and security explicitly in an effort to determine a preferred distribution of expenditures.[7] However, the compartmentalization of security and economic issues among the allies that has characterized most of the postwar period has worked well for both sets of issues, and it should be preserved if at all possible.[8] Security-related discussions will inevitably be dominated by defense and foreign policy officials, at least in the United States, raising doubts about the efficiency and domestic sustainability of any economic decisions that might be taken. Perhaps most importantly, it would be very difficult to engage Japan—the major target of the effort—meaningfully in the defense context, and it would be virtually impossible to multilateralize such discussions with Japan and Europe simultaneously.

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[7] It has been proposed (Hale 1988) that the United States should explicitly return to the "military offset" arrangements of the 1960s. Under these agreements, Germany (and a few other European allies, to a much lesser degree) committed itself to buy a large quantity of military equipment from the United States and to invest in special Treasury securities to cover any remaining net foreign exchange cost to the United States of its military programs in Germany. In addition, Germany committed itself in 1967 not to buy US gold with its dollar reserves. The United States itself decided to drop the offsets, however, because they destroyed the compartmentalization of security and economic issues and thus raised major political problems abroad (and were widely viewed as causing the downfall of German Chancellor Ludwig Erhard in 1966). Moreover, today's linkages among issues must extend much more widely than in the 1960s—into foreign assistance, debt relief and other matters that would be extremely difficult to tie to troop levels and sales of military hardware. The more far-reaching approach suggested in the text would appear more desirable. Increased military spending by the allies would, however, simultaneously contribute to better burden sharing and stimulate domestic demand in the surplus areas as proposed in Chapter 5.

[8] By contrast, the United States has consistently linked security and economic issues vis-a-vis the Soviet Union (and, to a lesser extent, vis-à-vis Eastern Europe and China). Japan and the Europeans have been much less inclined to do so, and this has been a frequent source of discord within the alliance.

The better course is therefore for the United States to make clear that the heavy costs of its own security commitments must be taken fully into account when new international economic arrangements are devised. Those arrangements should be negotiated between the United States and the other countries (notably Japan) within the framework of the existing IFIs. The basic approach would be to seek a sharp increase in the relative contributions to economic management from Japan, several European countries, and some "graduating" NICs. In return, these countries would be accorded a greater voice in managing the IFIs both through personnel changes and alterations of voting structures. The United States would retain its basic defense commitments. Specific proposals for each of the key institutions are made below.

ENTER GORBACHEV?

The international financial institutions can also play a useful role in addressing another potentially important issue, the possible reentry of the Soviet Union into the international economic system. The USSR opted out of the system shortly after participating in its creation at Bretton Woods in 1944, and since then it has remained a virtual nonparticipant in the world economy, both because of its ideological hostility toward the market-based exchange that characterizes relations among most nations of the world, and because of its autarkic and inefficient economic system.

The Gorbachev reforms, however, could produce a fundamental change in Soviet attitudes toward the world economy and even some changes in their international economic capabilities. But internal liberalization and the restoration of a price mechanism, however halting and limited, can only succeed if leavened by at least some exchange with the outside world. The desperate economic and political need to improve living standards in the Soviet Union will require the infusion of goods, technology, and money from the West. The experiences of China and several East European countries illustrate the essential linkages between internal liberalization and external exchange.

These precedents also indicate the role that the IFIs might be called upon to play vis-à-vis the USSR. The IMF, and especially the

World Bank, have helped to influence the economic leaderships in China and Hungary, and to guide those nations' increasing interactions with the West. Similar developments may now occur in Poland. One of the great (if unheralded) diplomatic successes of the past decade has been the quiet movement of China into closer contact with the world economy, partly through its involvement with the international financial institutions.

The Soviet Union has now put out feelers toward the IMF and the World Bank, and, after applying for observer status at the GATT's Uruguay Round, it has stepped up its efforts to join that organization.[9] To date, the response of the United States and the other members of these organizations has been negative: noting that the Soviet economic system is fundamentally incompatible with the operating premises of these organizations, which are based largely on market forces, the members have essentially rejected any overtures until the Soviet system has been radically transformed. Beneath this concern lie deep worries that Soviet entry—particularly to the Bretton Woods institutions, with their weighted voting arrangements—would require wholesale restructurings that would take considerable time and could politicize these largely technical bodies.

All such concerns are understandable, as are doubts that the Soviet Union really wants to join the IFIs for constructive purposes (or that Gorbachev's reforms will last). Nonetheless, even a partial integration of the USSR into the world economic system would represent a potentially historic breakthrough in political and security terms. The case of China, in particular, demonstrates that the IFIs could play an important role in such a development. The precedents of all the Communist countries indicate that the "entry fee" issue is manageable, though complex (especially in the GATT), and that fears of politicization have been unfounded.

Indeed, it would seem highly desirable to channel toward the IFIs any credible effort by the USSR to begin engaging in extensive economic exchange with the West. This is the least political, and hence most effective, way to get accurate data on its economy, to bring outside influence to bear both on its internal reforms and its internationalization; and to avoid, or at least coordinate, the inevitable scramble among western countries seeking to gain a competitive foothold in this "vast new market."

This is another potentially important role for the IFIs, reinforcing the case for the new administration to work to strengthen them. Seizing the opportunity offered by the Gorbachev reforms to begin to engage the Soviet Union in the world economy could have a significant impact on the international orientation of that country and thus enhance the prospects for world peace.

BUDGET CONSTRAINTS

Another important reason why the United States should support the IFIs is their cost-effectiveness. The United States must carry out the ambitious strategy proposed in this volume in the context of substantial overall cuts in government spending. Hence the need for efficient policy instruments is greater than ever before.

The IFIs fully meet this test. The United States can support the expansion of these institutions' Third World debt program with very modest budget outlays. In the latest General Capital Increase (GCI) for the World Bank, for example, only 3 percent of members' subscriptions is actually paid in. The remaining 97 percent is provided in the form of callable capital, a guarantee against the Bank's repayment of its borrowings in the international capital market. (These borrowings provide the actual resources that the Bank lends to debtor countries). Under congressional rules worked out in the 1970s, only the paid-in portion of World Bank capital subscriptions requires budget outlays. Callable capital is included in appropriations legislation (and requires full authorization), but would count as an outlay only in the unlikely event that the capital was ever called.[10]

Since the US share in the Bank's total capital is now under 20 percent, and only 3 percent of new subscriptions are paid in, every dollar of US contributions supports over $165 of new Bank credits. To the extent that the Bank can use its guarantee and financing programs to generate additional lending from private sources, this leverage is even greater. The ratio is not quite as impressive in the regional development banks, but it is still about 1:40 in the IDB. The IFIs provide a great deal of "bang for the buck" in terms of nonconcessional lending to debtor countries and others in the Third World.[11]

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[9] Increased interest in joining GATT was indicated by Soviet Foreign Economic Relations Minister Konstantin Katushev in an interview with the Japanese newspaper *Kyodo*, 22 August 1988.

[10] Even if one doubted the creditworthiness of new World Bank loans and the adequacy of its reserves of $8.5 billion to handle any repayment problems, over $85 billion of callable capital is already available to the Bank from its past capitalizations and would be drawn before new callable capital would be tapped.

The resources of the IMF consist of member country quotas (the General Account) and Special Drawing Rights (SDRs; the Special Account). Increases in either require no budget outlays by the United States at all. Under the guidelines developed in the late 1970s, quota increases (like World Bank callable capital) are included in appropriations as well as authorizing legislation, but no outlays are recorded.[12] Legislation from the early 1980s requires the administration to consult with the Congress before approving new allocations of SDRs, but these are not included in the budget at all—quite appropriately, since they represent newly created international money that carries no liability for any of the member governments.

Increasing program levels in the IFIs is thus a uniquely attractive policy approach from a fiscal perspective. Given the likely budget stringency of the 1990s, especially for the United States but also for many other countries, the IFIs deserve special attention.

AMERICAN LEADERSHIP

An overarching theme of this analysis is the need for the United States to develop a new leadership role that corresponds both to its own increased dependence on the world economy and its reduced, though still potent, ability to influence international economic events. It is clear that the new economic management structure of the world must be multilateral, with at least Japan and Germany (or a united Europe) at the core of the directorate. The United States will find it increasingly difficult to pursue its objectives effectively through unilateral or bilateral steps, although such approaches may work on occasion and small steering groups (such as a G-2 arrangement with Japan or a G-3 with Japan and Germany) will often be needed to guide the course of the formal institutions (Bergsten, Berthoin, and Mushakoji 1976).

Because of their multilateral nature and weighted voting, the IFIs provide a ready-made framework within which the United States can pursue its new leadership role. These institutions may frequently represent the best channel to pursue direct US interests, such as avoiding an international financial crisis or increasing import capabilities in Third World countries. They may also be the best places to pursue indirect but important US interests, such as more sensible economic policies in LDCs. The two goals will often fuse: the United States has a major developmental as well as export interest in trade liberalization in LDCs, for example, so support for IFI efforts to achieve policy reforms in return for new credits can be a valuable element in the overall strategy suggested here.

The European situation also supports the case for an American effort to boost the role of the international institutions in finance and trade. As the European Community moves toward its "single internal market," closer policy coordination, and possibly even a European central bank, it will inevitably tend to emphasize regional issues at the expense of global ones. This would be ironic, since the achievement of greater internal cohesion would strengthen Europe considerably and enable it to play a larger international role, a development that would be very much in America's interest. The United States thus has a special incentive to launch initiatives that will foster a larger role for the global institutions, challenging Europe to participate in them fully rather than turning inward to its own organizations. An effective system of pluralistic economic management requires Europe to play a central role, and the present period is extremely important in ensuring such an outcome for the 1990s and beyond.

The IFIs are not by any means perfect, either from the standpoint of the national interests of the United States or those of other nations. But they have achieved considerable success under extremely difficult circumstances through several decades of rapid change in the world economy. They would have to be invented now if they did not already exist. The United States, which led the creation of all of these institutions (except the African Development Bank) during its hegemonic period, can now use them to great advantage as it seeks a new and more complicated leadership role. To achieve the US policy goals that have just been elaborated, new initiatives are needed in the World Bank, the IDB, and IMF, in particular.

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[11] Each of the IFIs also has a concessional lending window for its poorest member countries, such as the International Development Association (IDA) of the World Bank. All contributions to these programs require full budgetary appropriation, and thus have much less financial leverage. They are still quite useful in this respect when compared with bilateral programs, however; the US share in IDA is about 25 percent so every dollar of US budget outlays there triggers $4 in total assistance to poor countries.

[12] The reason in this case is that the United States receives a claim on the IMF in return for its "contribution" of dollars, which entitles it to draw hard currencies such as yen and DM when needed, so the transaction amounts to an exchange of assets rather than a net payment.

THE WORLD BANK

The World Bank needs to take several important initiatives to lead a more effective response to the problem of Third World debt. Most importantly, it needs to increase sharply the level of credits that it can make available to the main debtor countries. This would help induce those countries to adopt better policies, reduce the negative financial transfer from them, and enable the Bank to solidify its leadership on this issue for the foreseeable future.

Under current plans, the Bank intends to expand its annual new commitments to all borrowers from about $15 billion in FY 1988 to about $21 billion by FY 1992. This increase requires additional resources, and the membership voted in early 1988 for a General Capital Increase (GCI) of $75 billion. The Congress approved in September 1988 the US subscription to the GCI, which will require budget outlays of only $420 million over the entire six-year period.

The currently planned increase in Bank lending under the GCI, however, will make only a modest contribution to reducing the $30 billion annual negative financial transfer from the Baker 15, to which the Bank "contributed" over $1 billion in FY 1988. The Bank should thus take three additional steps. First, it should be prepared to raise its annual commitments to at least $25 billion as soon as possible (rather than $21 billion by 1992). Its actual ability to lend such amounts will depend on whether borrowing countries can provide enough worthy projects and policy reforms, and no arbitrary lending targets should be set. But the Bank should stand ready to offer generous support for worthwhile projects and programs at considerably higher levels than now planned.

Second, the Bank should make much larger amounts available through "structural adjustment loans" and sector loans, to support more far-reaching policy changes by borrowing countries. This would help to increase the level of its transfers and speed their disbursement, as well as respond to the major development needs of many of the Bank's largest borrowers during this period. Instead of lending $1 billion to Mexico to facilitate its substantial steps toward trade liberalization (along with another $1 billion for sectoral reforms) in FY 1988, for example, the Bank could offer to lend $2 billion to finance even more sweeping liberalization (including on inward FDI) and some of the internal adjustments that would be required as a result.

Third, the Bank should launch a temporary program under which it would guarantee exit bonds issued by debtor countries with effective adjustment programs to banks that are prepared to convert their existing loans at a considerable discount. Mexico's arrangement with Morgan Guaranty in early 1988 sought to persuade banks to undertake such a conversion, but the result was modest because the lenders did not see much greater assurance of interest payments on the new paper than on the old. A Bank guarantee of such payments could transform such arrangements, enabling even the largest debtors to cut their outstanding liabilities significantly. This would give the Bank a major role in inducing commercial banks to reduce their claims on debtor countries, as a number of its congressional critics have advocated.

If exit bonds were sold at an average discount of 50 percent from the face value of existing bank loans (in accord with current prices in the secondary market), and were paid off in eight years, as much as one-third of the bank debt of the 17 highly indebted middle-income countries could be converted. This would reduce the value of the debt by as much as one-sixth, or about $45 billion, at the cost of a contingent claim on the Bank's newly available callable capital that would not compete with its traditional lending program because the new claims would begin falling from their peak after four years. The main problem would be to provide adequate cash flow to the debtor countries in the interim, enabling them to service the bonds as well as meet their other foreign exchange payments.

This could be done partly by persuading the banks that did not exit to offer sufficient new capital to facilitate the substantial improvement in the countries' long-term positions (and thus the value of the banks' own claims).[13]

These new uses of the Bank's resources would have two important financial consequences. First, they would require the United States and the other key donor countries to speed up the timetable under which they actually pay in their subscriptions under the GCI, thereby providing the Bank with the capital it needs to accelerate its lending and guarantee programs as proposed here.[14] The United Kingdom, the first of the major donors to fulfill its subscription, did in fact pay the total amount in a single installment. Second, the changes proposed here would also require a modest advance of the date on which another GCI would have to be considered—perhaps from 1993 to 1992. Given the small costs of Bank capital to the donor countries, and the high payoff from its programs, these changes should be acceptable.

An additional source of funding for the Bank could be an early Selective Capital Increase (SCI), through which the major creditor countries would further augment the Bank's capital in return for a corresponding increase in their voting rights. Japan would certainly participate, and the NICs and perhaps a few Europeans should do so as well. This would be an effective way to increase the contribution of newly wealthy countries to the stability of the international economy. Relative shares could be determined at least in part through the discussions on improved burden sharing proposed above.

An alternative to using the Bank's regular capital to back the new program of exit bond guarantees is to create a separate window in the institution for this purpose. Such a facility could be mainly or entirely capitalized by those countries, led by Japan, that have experienced a rapid improvement in their relative income positions and that have also been running external surpluses. This approach would thereby also contribute to the objectives of correcting the current imbalances—because these countries' funds would help finance expanded US exports to the debtor countries—and to better global burden sharing. The facility might be able to leverage its capital to a substantial extent, guaranteeing exit bonds valued at five to ten times its own resources. (The Bank's Articles of Agreement prohibit this kind of leveraging of the capital of the Bank itself.) Backing the new guarantees through a separate facility would free the Bank's resources for the proposed expansion of its lending program without any need to accelerate payments under the present GCI or advance the date of the next one. Such a facility would take longer to start up, however.

After these new initiatives were under way, the only significant constraint on Bank programs would be its ability to use its money wisely and elicit meaningful commitments from borrowing countries. The debt crisis is already pushing many of the large borrowers toward policy reforms, and expanded Bank lending can be made available with greater confidence than in the past. But it will be essential that the Bank insist on effective structural reform programs in fashioning its loans, and that it use its increased resources to induce such efforts. The Bank will have to demonstrate that it means business by withholding funds from countries that fail to implement their policy commitments faithfully, or by denying loans in the first place to those who will not make meaningful commitments. There can be no arbitrary fulfillment of lending targets, simply to achieve a desired level of capital transfer.

With these additions both to the quantity of its lending and the breadth of its programs, the Bank will be in a strong position to assume leadership in managing the debt problem. The debt issue now approximates a three-ring circus—comprising the governments of the debtor countries, commercial lenders (mainly banks), and the governments of lending countries (independently and working through the IFIs)—without a ringmaster to direct the participants in a cohesive performance. The IMF, as noted above, can no longer lead. Former Secretary Baker succeeded in filling part of the vacuum and avoiding a financial crisis during the past three years, but his Baker Plan has fallen far short of success, and no single country can organize a successful debt resolution effort. Since the problem is now clearly of a long-term character, and is thus intimately linked to the development prospects of the Bank's borrowers, Bank leadership is appropriate. This further supports the case for enhancing its programs through the measures proposed here.

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[13] This proposal is developed in Williamson (1988b). The exit bonds could also be structured with much longer maturities, at the cost of adding to the potential net use of IBRD resources. On the other hand, the Bank could limit its exposure by guaranteeing the bonds partially rather than fully.

[14] The United States may need to accelerate its payments, in any event, to keep its voting share in the Bank from falling below the level required to maintain veto power over charter amendments and a few other major decisions. This will certainly be the case in the event of a substantial Selective Capital Increase with rapid pay-in, as proposed below, through which Japan and other countries would fund an increased share of bank capital as part of the broader reallocation of economic burden sharing advocated throughout this volume.

If Japan were willing to provide a sufficiently large part of the increased capital needed by the Bank, it should receive in return not only the normal increase in voting power, but serious consideration for its nationals for the presidency of the institution. The original rationale for an American president for the Bank, in addition to the dominant shareholder position of the United States at the time, was that virtually all the Bank's borrowing occurred in the US capital market. But Japanese investors have reportedly been buying up to one-half of all new bonds issued by the Bank in the world's capital markets. If Japan, now by far the world's largest creditor country, is willing both to provide the bulk of the Bank's funds and to back its capital with considerably larger governmental guarantees, the Bank's traditional criteria would suggest that the next president should be Japanese if a qualified candidate is available.[15]

The markets and the other countries will want the United States to maintain full support for the Bank at the same time, to ensure that the institution will in fact be able to play its new key role. For its part, the United States can only retain the leadership role advocated throughout this volume if it fully supports the activities of the Bank. This will require accelerated payment of its subscriptions under the GCI and efforts to convince other governments to do the same; support for an SCI that increases the share of Bank capital made available to Japan and others, as they increase their financial contributions; advocacy of a larger and faster disbursing lending program and new guarantee authority; acceptance of a lead role for the Bank in managing Third World debt; and support for a more diversified leadership structure in the organization.

These changes in US policy toward the World Bank would form an important part of the overall shift in the international economic role of the United States in the 1990s. They would also help to achieve two of the core objectives of America's foreign economic policy: a correction of the external deficit (by promoting the expansion of US exports to Third World markets) and a reduction of the risk of financial instability (by providing a more effective response to the debt problem).

THE INTER-AMERICAN DEVELOPMENT BANK

Similar changes are needed at the Inter-American Development Bank. The starting position there is more complex, however, because the United States has brought the institution to a virtual halt over the past three years by insisting on near-veto power on individual loans as a quid pro quo for supporting the capital increase needed to permit increased lending.[16] New loan commitments dropped from $3 billion in 1986 to $2.4 billion in 1987, and the IDB is now on balance withdrawing funds from the hemisphere (about $1 billion in 1987 and 1988 from Argentina, Brazil, and Mexico).

The American demand for greater power in the Bank obviously runs counter to the more pluralistic management strategies recommended throughout this book. The futility of this course is demonstrated by the refusal of the other members of the Bank, including nonregional donors (from Europe and Japan) as well as the Latin Americans, to accept it, despite the dire economic straits of the borrowing countries and their need for IDB capital. The US initiative should be quietly shelved, in return for firmer commitments from the Bank's new management on the quality as well as the quantity of future lending.

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[15] Current Vice Minister of Finance Toyoo Gyohten would be a strong possibility. Similarly, the time has come to end the anachronistic reservation of the top management positions in the IMF and GATT for Europeans. An eminent American, such as Paul Volcker or William Brock, should certainly be eligible to head the Fund or GATT. An effective leader from outside the Big Three, such as Prime Minister Bob Hawke of Australia after he leaves office, could lead the GATT. These institutions will be so important in the 1990s and beyond that the best person available should be sought to run them regardless of nationality or implicit political deals from the 1940s. The member countries will have to make their most qualified people (including government officials) available for both top staff positions and as Executive Directors, which they—notably including Japan and the United States—have not always done.

[16] A somewhat similar, if less damaging, sequence has occurred in the Asian Development Bank (ADB). Japan has proposed a sharp increase in the Bank's capital, but the United States has opposed the idea in part because of a fear that it would lose voting power if it failed to match the Japanese subscription. The ADB is in fact a very useful vehicle for channeling Japan's surplus funds to developing countries in Asia, and an increase in its share in that institution would promote better burden sharing among the allies.

There are valid concerns about the efficiency of the IDB, however, so US strategy there should be more limited in magnitude and more cautious than in the World Bank. The main goals should be similar: larger loan commitments to encourage recipients to adopt more effective policies; expeditious approval of a capital increase (of perhaps $25 billion), to enable the Bank to increase its level of new commitments (perhaps to about $6 billion per year); and more rapid disbursements through increased emphasis on program and, especially, sector loans.

Because of concerns about the performance of the IDB, its loans should be offered in conjunction with those of the World Bank whenever possible. The IDB has several unique advantages, however, that the United States should seek to exploit. As an inter-American institution, with majority participation by Latin Americans, it has greater legitimacy than the Bretton Woods institutions among the governments of some of the chief debtor countries and can thus be especially effective in eliciting their cooperation on policy reforms. The IDB could take the lead in coordinated efforts with the World Bank in some cases, while deferring to its primacy in others.

THE INTERNATIONAL MONETARY FUND

Like the World Bank and the IDB, the Fund must make a larger contribution to the resolution of the Third World debt problem.[17] In addition, it must play a central role both in the proposed adjustment of the massive international imbalances among the industrial countries and in the reform of the international monetary system. By addressing these tasks, the IMF can also be an important vehicle for improved burden sharing and a new international economic leadership role for the United States.

On debt, the IMF can provide major assistance in achieving the policy reforms required of the debtor countries. Its programs should increasingly emphasize structural adjustment for the longer run through such steps as trade liberalization, the removal of restrictions on foreign direct investment (to enhance the utility of debt-equity swaps among other things), and the liberalization of domestic capital markets. As the World Bank moves toward more active leadership of the debt problem and the Fund's loans become more oriented toward structural adjustment, IMF approval of country programs should increasingly be coordinated with those of the Bank. In fact, it would be desirable to create a joint Bank–Fund unit to develop and monitor at least some of the country programs in which both institutions are involved, or for the two institutions to at least prepare joint policy strategies for key borrowers from both.[18] However, the Fund's independent imprimatur will remain extremely important to the commercial banks and other private lenders regarding the financial soundness of country programs and potential new loans.

The fact that the IMF is a revolving fund is exacerbating the debt problem because some of the major debtors are now repaying Fund loans drawn during the first stage of the crisis in the 1982–84 period, creating a negative financial transfer of about $1 billion to the Baker 15 in 1987. By contrast, the Fund extended net new credits of $6 billion as recently as 1983. Ways need to be found, consistent with the basic character of the Fund, to avoid such net repayments until the overall debt situation is much more stable.

The best way to encourage better borrowing-country policies and to improve their financial positions is to increase the level of credit that is available to them under new agreements with the Fund.[19] The first step in this direction is to use the Fund's current programs much more aggressively. Liquid resources now available total almost $50 billion. Under the "enlarged access" policy, adopted in 1981 and modified subsequently on several occasions, countries can borrow up to 90 percent of their quotas in a single year, and cumulatively up to 400 percent of their quotas. However, few new programs are providing annual tranches that fully utilize these ceilings. The Fund should thus begin to transfer considerably larger amounts to its borrowers, especially to the debtors now experiencing net negative transfers, if these nations are willing to commit themselves to effective policy reforms.

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[17] It has recently taken two useful steps in this direction: creation of the Enhanced Structural Adjustment Facility to provide longer-term assistance to its poorest member countries, and creation of the Compensatory and Contingency Finance Facility to provide credits to offset, inter alia, the impact of higher interest rates on borrowing countries (as originally proposed by Cline 1980).

[18] Three-year rolling programs are now being prepared jointly for the poorer member countries borrowing under the Structural Adjustment Facility and Enhanced Structural Adjustment Facility. This model should be extended to the middle-income debtors and stretched over a considerably longer time horizon.

[19] This is superior to the alternative of rescheduling of present loans, which would raise questions about the Fund's own creditworthiness and could impede the process of parliamentary ratification of its new programs in some countries (including the United States).

Such a policy change could lead rather quickly to larger programs for a number of countries, so there should also be an early increase in the quotas of all members. The present enlarged access should be increased back to the original limits of 150 percent of quota annually and 600 percent cumulatively, pending the quota increase, and either held there or dropped no further than the present limits when the new quotas are activated. These further increases in the availability of financing will enhance the incentives for borrowers to meet Fund conditions. So would a lengthening of the maturities of new Fund credits, which would reduce the chances of again generating negative net transfers prematurely.

The Fund was scheduled to consider a quota increase in 1988, but it deferred the issue for a year at the request of the United States, which wanted to avoid approaching the Congress before it had acted on the GCI for the World Bank. The issue is now scheduled for consideration in early 1989, and the new administration—after close consultation with the Congress—should seek a doubling in Fund quotas from their current level of about $100 billion. Along with the maintenance of "enlarged access," and an increase back to the earlier level of 150 percent of quota for annual drawings, at least until the new quotas are in place, this would enable the Fund to increase substantially its new loans to debtor countries (and others) with effective adjustment programs.

Such a quota increase would also have direct benefits for the United States. As described in Chapter 5, the United States could face a difficulty in financing its continuing current account deficits over the coming years, even if it adopts a fully credible adjustment program. Its financing needs will be even greater if it fails to do the latter. In either case, the United States may have to acquire large amounts of foreign currencies to share the exchange risk involved in such financing if private lenders are unwilling to buy enough dollar assets at acceptable prices and if foreign central banks insist on such sharing.

US holdings of foreign currencies are rather limited relative to its potential requirements for intervention, however, and the acceptance of new foreign currency liabilities (through the activation of the swap network or the issuance of foreign currency debt) would be extremely risky unless full market confidence had been restored. An IMF quota increase of 100 percent would augment the potential resources of the United States by about $25 billion, of which about $6 billion would be available immediately and without conditions. It should be recalled that the United States drew about $3 billion of DM and yen from the Fund as part of the dollar defense program launched in November 1978, and drew from the Fund on more than twenty other previous occasions.

A sizable quota increase and more extensive lending to the large debtor countries would help revive the global role of the Fund.[20] This would promote the interests of the United States by pluralizing the management of the international economic system in an organization that is demonstrably effective. Such a renewed role for the Fund, together with that of the Bank, should be a major objective of the foreign economic policy of the new administration.

The United States should seek the strengthened Fund's help in promoting the necessary adjustment in the current account imbalances of the major industrial countries and, especially, in maintaining new equilibrium exchange rates and supporting national policies once they have been achieved. When the United States announces the goal of eliminating its current account deficit, as recommended in Chapter 4, it should look to the Fund to work out the implications for the world economy as a whole and to recommend how the adjustment can best be allocated among countries in order to minimize any adverse effects. In particular, the Fund will need to protect the interests of the LDC debtors during the adjustment process. It will also have to steer the effort, outlined in Chapter 5, to channel the maximum counterpart of the American adjustment to the surplus countries.

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[20] Another possibility is renewed allocations of Special Drawing Rights (SDRs), as proposed by Williamson (1984), and the Institute of International Finance (1988). The SDR could be used increasingly as an "anchor" for a reformed monetary system, and as an additional source of support for Third World debtors. However, world reserves have risen sharply during the past three years—mainly as a result of the sizable intervention by foreign central banks to support the dollar in 1986–87. The monetary character of the SDR needs to be preserved if it is to play a central role in the system over the longer term, and all proposals for new allocation need to be judged carefully against that standard.

As argued in Chapter 5, the United States has a major interest in reform of the international monetary system that helps to avoid another cycle of the huge currency and policy swings that have caused so much damage to the US economy, to its international financial position, and to the global trading system. Such reform, preferably in the direction of target zones and much more extensive policy coordination among the largest countries, will initially have to be negotiated and implemented by the G-7 (or an even smaller group of financial powers).[21] But such a reform can only become fully operational and legitimate if it is institutionalized in the IMF, the world body responsible for international monetary affairs. As current exchange rate arrangements evolve toward greater coordination, the Fund should play an increasingly central role. For a start, the Fund should publicize at least summary versions of its policy recommendations to countries under the present multilateral surveillance process, as proposed for the United States (through the Secretary of the Treasury) in the monetary policy chapter of the Omnibus Trade Act.

The IMF should thus figure significantly in the international economic strategy of the new administration. The United States itself will have to be willing to respond positively to Fund recommendations concerning its economy, as already suggested in the Omnibus Trade Act. As in the World Bank, Japan and a few other countries may need to be accorded larger voting shares, perhaps through special quota increases, to reflect more accurately the distribution of economic power and responsibility in the 1990s and beyond. Japan already has the second largest share of World Bank capital but remains only fifth in terms of IMF quotas—behind the United Kingdom, Germany, and France, as well as the United States. This anomalous situation needs to be promptly corrected, and the United States may have to push the Europeans hard to get them to agree. Japan should be asked to increase substantially its financial support for the Bank and IDA, as well as for the Fund itself, as part of this leadership shift.

CONCLUSION

These proposals for strengthening the role of the international financial institutions can be pursued most effectively if the new administration takes the three sets of proposals—affecting the World Bank, the IDB, and the IMF—to the Congress together in a single package. Rather than divorcing the component parts from each other out of concern for congressional hostility, as has been the practice during the past few years, the administration should link the institutions together in a single piece of legislation. This will highlight both their numerous benefits for US interests and the modest budget outlays they require.

Omnibus IFI legislation in 1989 should include full payment of the US contribution to the GCI at the World Bank, which would require only $370 million in budget outlays; perhaps $9 billion of additional capital for the IDB, of which only $225 million would be paid in; and about $25 billion for the increased US quota at the IMF, with no outlays. Linking these funding proposals together would dramatize the benefits of the institutions for the United States and their cost-effectiveness. Such an arrangement would of course have to be worked out in close consultation with the Congress. Indeed, one reason for packaging the proposals together is that the case for each could be made simultaneously, and the Congress is always more attentive when the magnitude of a proposed program is greater.

New initiatives toward the IFIs would have major advantages for the international economic policy of the United States, both at home and abroad. Domestically, it would signal a strong commitment by the United States to full and active participation in international economic affairs. Internationally, it would indicate clearly that the United States intended to follow the multilateral route to the maximum extent possible, because it recognized that this route supported its national interests both in economic and foreign policy terms. With a unified domestic front and a credible international commitment, the United States would dispel many of the suspicions of its motives that have arisen during the past few years. As a result, it will become much more effective in pursuing its interests in the institutions themselves, and more generally.

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[21] The possible tactical need to proceed first through a "G-2" between the United States and Japan, as Secretary Baker was forced to do by European footdragging in late 1986, is explored in Bergsten (1987a).

Most importantly, the proposed program changes in the three IFIs could make a major contribution both to the resolution of the Third World debt crisis and to the correction of the US external deficit, and do so in a way that will contribute to better burden sharing among the allies. Substantial increases in IFI lending levels, faster disbursements, and a new World Bank debt guarantee program could generate a sharp reduction—or even elimination—of the negative financial transfer of the large debtor countries over the next four years. This would enable these countries to grow faster and to sharply reduce their trade surpluses or even run deficits again, contributing substantially to the global adjustment. A significant expansion of the roles of the IFIs can thus simultaneously help address the problems of each of the two major debtor regions of the world, the northern and southern continents of the Western Hemisphere.

8

Implementing the Strategy of Competitive Interdependence

THE POLICY PACKAGES AT HOME AND ABROAD

The United States should implement the domestic portion of the strategy proposed in this volume largely through three new legislative packages: one for reduction of the budget deficit, another for export expansion, and a third supporting the IFIs. Each would contribute significantly to the correction of the huge US external imbalance, and also achieve other priority goals of the United States. Each would need to be worked out through extensive consultation between the administration and Congress. The three packages would relate closely to each other and would together form a comprehensive response to some of the most urgent economic and foreign policy problems that will confront the new government. If they are faithfully implemented, it will be evident at home and abroad that the United States is doing everything within its power to strengthen its international economic and financial position—the "competitive" element of the proposed strategy.

The international portion of the strategy would involve a series of major negotiating efforts: to coordinate national economic policies in a way that will eliminate the international imbalances while sustaining global growth and stability; to achieve equilibrium levels for the dollar and the other key currencies, and then keep them

Poor Man's Debt, Rich Man's Loot

As Loans Pour In and Capital Pours Out, the Third World's Elite Get Fatter

By James S. Henry

WALTER SEIPP, the usually circumspect chairman of Commerzbank, one of Germany's largest banks, had an unusual moment of candor at the International Monetary Fund's annual meetings in Berlin in late September. "I have not worked 16 hours a day for 40 years," he said, "so that some Argentine politician can salt away a fortune in Zurich."

Seipp was responding to the renewed demands for debt forgiveness that have lately come from many debtor countries. Only last week, for example, Mexico's new president, Carlos Salinas de Gortari, suggested in his inaugural address that more fundamental concessions would be needed even though Mexico is now digesting yet another $3.5 billion bailout from our Treasury. On the surface these demands seem reasonable. After a half-decade of piecemeal restructurings and bailouts, the gross foreign-debt burdens of Third World countries are now greater than ever.

Before we go lurching down the road toward a complete bailout for the banks and the borrowers, however, we should pay close attention to Seipp's rejoinder to the demands for debt relief. His remark called attention to the dirty little secret behind the Third World "debt" crisis—the huge stock of *untaxed* flight assets that has been accumulated offshore by the wealthy residents of the major debtors and not a few of their political leaders.

The assets held by these elites are now substantial enough that if the income they generated were sent home and taxed, it would go a long way toward servicing the debts. Of course, this is unlikely to happen. Along the road to debt relief, however, it seems reasonable for Third World countries to get help from their wealthy elites as well as from the rest of us.

Help from somewhere is certainly needed. In addition to basket cases like Peru, Egypt and the Ivory Coast, Argentina totters on the brink of Peronism and default; Brazil's accord with its bankers may not survive next year's presidential campaign; Venezuela faces prolonged recession and rising political opposition to debt service.

From Mexico City to Manila, most of the debts now belong to unproductive, inefficient government sectors, while much of the corresponding assets have been privatized and expatriated. The burden of servicing the debts is carried by some of the poorest people in the world, while the assets have been expropriated by a trans-national elite. In countries where inequality was already extreme to begin with, excessive public borrowing and the capital flight that it financed have amounted to a huge negative Marshall Plan, a massive milking carried out by foreign bankers who should have known better, in collusion with their own leaders and elites.

Many aspects of Third World flight capital are obviously off the record; tax-haven attorneys and private bankers are paid quite well to conceal them. But it is possible to estimate the volume of flight flows and assets indirectly, by adding up the identifiable uses of foreign funds, such as current deficits, and the accumulation of foreign reserves and comparing them with debt and investment. There is also quite a bit of evidence from the Treasury, the IMF and the Bank for International Settlements on where the flight dollars end up. Finally, this author has located many private bankers—including Swiss ones—who have been willing to talk about their murky trade on a "no names" basis.

Once assembled, these data cast a new light on the Third World debt crisis:

- Fifty percent or more of the money borrowed abroad by the most important debtor countries in the 1970s and 1980s flowed right out the back door in the form of private flight capital. In Mexico's case, the private flight share was about 51 percent; in Argentina's case, over 70 percent. Brazil had more reasonable exchange rates, capital controls and more attractive domestic investments, so its flight share was only 20 percent.
- Over this same period, interest charges and management fees paid by these countries on foreign loans were even larger than capital flight. For the Latin American "Big Four," interest expenses alone consumed over two-thirds of all new foreign loans and investments. Lending to Latin America has in fact been phenomenally profitable for most major banks and syndicators, yielding returns on equity of 50 percent or more per year. In fact, if we treat any interest above ordinary profit rates as a return of principal, our banks have already been more than fully paid back by the countries.
- Third World flight assets are now probably worth at least $600 billion, compared with their foreign debts of about $1.2 trillion. This is a conservative estimate, based on IMF and Morgan Guaranty data on the "sources and uses" of foreign capital by developing countries. This large accumulation is partly due to the fact that income earned on these investments is almost entirely reinvested, and partly due to the fact that it is largely tax-free.

These accumulations mean that, except for Brazil, the private sector of every major Latin borrower has nearly enough assets abroad to more than pay off both public and private foreign debts—even at their face values. And, of course, most of the Latin debts are now trading on the secondary market for 50 cents on the dollar, so that flight assets actually exceed the market value of the debt by a wide margin.

- Most of this Third World flight capital has ended up in the United States, Great Britain and Switzerland. Because investments by nonresidents go virtually untaxed, all three qualify as havens for Third World investors. The United States has actually been a net debtor of all the major "debtors" except Brazil for some time. It is, in fact, now one of the world's largest tax havens.
- U.S., British and Swiss banks have been major conduits for these reverse flows, and their Third World private banking business has, if anything, been even more profitable (on a return-on-equity basis) than their Third World lending, earning returns up to 200 percent a year.
- Ownership of this tax-free Third World flight capital appears to be concentrated in the hands of a tiny fraction of Third World residents.

These generalizations can be made more precise by looking at the case of one major debtor, Mexico, arguably the most important debtor to the U.S. and certainly the world's largest single flight-capital market. Until recently, many bankers cited Mexico as proof that the negotiated approach to debt problems was still working.

However, in the last six months the Mexican situation has become unraveled again. The country is back in a recession with no end

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in sight, political opposition to the foreign interest bill is rising and its reserves are taking a hit from falling oil prices, rising interest rates and Hurricane Gilbert. Furthermore, several of Mexico's recent experiments with debt relief have been fiascos, including the Morgan debt swap last March and a major privatization in June.

Throughout all this, the basic government policy with respect to the foreign debt has been to be a "good boy." Despite a large and increasing negative net transfer to its creditors, Mexico has stuck with the approach to debt restructuring preferred by its bankers, stubbornly resisting efforts to draw it into a "debtor's coalition."

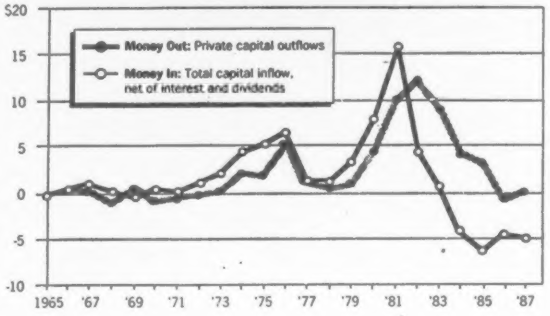
In retrospect this has not been cheap. From 1983 to 1988, for example, Mexico forked over about $33 billion in interest to its foreign creditors, while receiving back only $13 billion in net new foreign loans. Up to half these loans came from official institutions like the IMF or World Bank. With annual interest payments totaling 6 percent or more of gross domestic product, and a savings rate of 20 percent, Mexico transferred close to a third of its domestic savings abroad each year.

Mexico's *total* net transfers of capital abroad have been even larger, since it was also the world's largest flight capital/private banking market. Taking private capital flight into account, Mexico was actually a "net lender" to the outside world from 1982 to 1987, to the tune of nearly $50 billion. Meanwhile, its gross foreign debt continued to increase by nearly $20 billion.

Of course Mexico's gross foreign debt, although a nice big number, is really a completely meaningless abstraction. A much better measure is provided by the *net* foreign debt, after taking into account the substantial ownership of foreign assets by individual Mexicans. This shows that while the public sector's foreign debt has increased significantly relative to GDP since 1982, Mexico's total net foreign debt has actually declined, because the private sector's foreign assets are now (almost) equal to the public sector's debt.

CAPITAL FLIGHT IN MEXICO

IN BILLIONS OF 1980 DOLLARS



SOURCE: IMF Data, Henry analysis

MICHAEL DREW—THE WASHINGTON POST

In short, Mexico's problem—and, I would argue, the problem of most Third World debtors—is not really one of an excessive *total* debt burden. Mexico's ratio of debt service payments to exports is high, but not unprecedented—Britain, for example, had a much higher debt/export ratio in the early 1920s without losing access to foreign capital markets. Rather, Mexico's problem is how that burden is distributed—who got the loans, who spent them, who owns the flight capital, and, ultimately, who pays taxes and the foreign interest.

Now private investors in most developed countries are free to invest their savings abroad—why shouldn't Mexicans also be? Except for 1982 there have not been exchange controls in Mexico, so their foreign wealth is not illegal *per se* (as it would be in several other Latin countries). Presumably the bankers are not unhappy with this situation, either, since a large fraction of flight money has been redeposited with foreign banks—often the same ones that Mexico borrowed from in the first place. As one Citibank banker—operating, for the convenience of Mexican investors wanting to export their capital, out of the bank's beautiful Mexico City tower—told me in July: "We could easily more than repay the debt that Mexico owes us with the private banking assets we have in New York and Geneva from Mexicans."

Of course, that won't happen by itself because the assets are held by wealthy individuals and the debt by their governments. Instead, the rest of us—including the vast majority of Third Worlders who have no foreign bank accounts, the international lending agencies and the U.S. taxpayer—have been bearing the costs of servicing the debt and providing debt relief.

In Mexico itself, the distribution of this debt burden has been extremely inequitable. First, there are few productive assets to show for all the debts—many Mexicans now wonder how much of the flight was directly financed by the loans, via kickbacks and commissions. Second, the bill for debt service has mainly been paid either through an "inflation tax," or with the help of restrictive policies that generated trade surpluses by cutting imports and raising unemployment. Many Mexicans now actually have lower per-capita incomes than in the early 1970s, before the borrowing spree began.

Debt service has *not* been paid for with income or wealth taxes. Indeed Mexican income tax revenues have been declining in real terms throughout the 1980s. In theory, Mexicans, like Americans, are subject to taxes on their worldwide incomes, including capital gains and most forms of investment income. In practice, however, income from capital—whether foreign or domestic—and estates goes virtually untaxed. For example, the interest received on government securities is tax-free, in order to compete with U.S. bank CDs! Since the United States now exempts interest that its banks pay to non-residents from taxation, this forces Mexico to do so, too, to compete with our banks. As a result, Mexico's overall annual tax revenues are only about 11 percent of GDP, compared with over 30 percent in this country. Overall, labor, not capital, foots the tax bill in Mexico.

All of this may help to explain why the Mexican government has up to now been so well-behaved with respect to its foreign bankers. As one former senior advisor to former president de la Madrid himself told me in 1986, "Well, where do you think I have my money?"

Since most of these Mexican flight assets are now in the United States, why couldn't the U.S. Treasury just tax them and hand the revenues over to the Mexican government? This would not be easy for any single country to do on its own. Such a tax would probably just be a boon to tax lawyers in Panama and the Antilles, and for the Swiss or British bankers who would swoop down to redirect flight money towards themselves. Perhaps most important, such a tax would, more than any other in history, confront powerful opponents on a worldwide scale—including the U.S. Treasury itself, which likes to finance our own huge deficits with foreign funds.

But at least this "ideal world" proposal and the facts surrounding it may lead us to ask why, for example, there is no tax treaty between the

U.S. and most Latin countries after decades of negotiation; why the U.S. has taken giant steps in the last decade toward becoming one of the world's major tax havens; and why countries like Mexico can't do much more on their own to attract foreign investments and reduce their dependence on foreign loans and handouts.

Of course, there is another way to look at the Third World assets now gathering dust in New York and Genevan banks. Oddly enough, they may well be the one real glimmer of hope in the otherwise still-gloomy debt situation. For they mean that the Third World loans did not just go up in smoke—that some day, beyond the crisis, when the debts have been forgiven, the bailouts have been completed, and the flight dollars fly home, Latin America may well get rich!

James Henry, a New York economist and lawyer, is writing a book on Third World debt and flight capital to be published by Alfred A. Knopf Inc.

Chapter 11 Workouts for Latin Debtors

By Shafiq Islam

With heightened crisis further destabilizing Mexico, Brazil and Argentina, the Third World debt problem is dominating the meeting of officials of the Group of Seven industrial countries in Washington.

The foreign ministers and central bank governors would like to know from their U.S. counterparts what the Treasury has come up with after taking a "whole new look" at the debt problem that President Bush promised the week before Christmas. All indications are that they will be disappointed: The new look is still yielding old ideas on how to combine "involuntary new money" with "voluntary debt reduction."

The problem is that the Treasury's "whole new look" is still avoiding coming to terms with a simple unpleasant fact: The troubled countries are overindebted—their foreign obligations are too high in relation to their current and future capacity to service them. This obligation-capacity gap is not temporary even for the middle-income countries, but will persist to varying extents under all reasonable future scenarios. In other words, the debtor countries are not suffering from a liquidity shortage resulting from a temporary decline in their capacity to pay, but a solvency problem where their debt-servicing obligations are simply too high. Therefore, what these debtors need is not more "new money," but less "old debt"—they need debt relief.

An effective strategy must aim at closing the capacity-obligation gap with economic restructuring to improve the debtors' capacity to pay, and debt restructuring to reduce their obligations to pay. The official debt strategy has been doing the opposite—widening the solvency gap by forcing the debtors to transfer resources through policy adjustments that weaken their capacity to pay, and at the same time forcing them to take on "new money" that increases their obligations.

Menu Approach

The market has increasingly recognized the fatal flaws in the official debt strategy. As the secondary market prices of LDC loans continue to slide, banks are increasingly participating in "voluntary debt reduction" through debt-equity swaps, loan-bond swaps, debt buy-backs, exit bonds, and so on. The market's menu approach, however, has major defects as well. First, it fails to fully translate debt reduction into debt relief for the countries: A substantial part of the discount ends up in the hands of traders, banks and multinational companies. Second, debt-equity swaps and schemes involving local currency payments widen the debtors' budget deficits, compounding the existing fiscal and inflationary pressures. Finally, and most important, instruments of voluntary debt reduction neither encourage policy reform nor provide the extent of relief that many debtor countries need to restore investment and growth.

So involuntary new money and voluntary debt reduction only compound the debt problem and reschedule its resolution. What is needed is a negotiated and coordinated approach to debt and economic restructuring on a country-by-country basis. (The real choice is not between voluntary debt reduction and mandatory debt forgiveness, but between an uncoordinated approach producing negligible debt relief and a coordinated one supporting policy reform with substantial debt relief.) The proposed restructuring should be guided by three basic principles.

The first principle follows the logic of Chapter 11 of the U.S. bankruptcy code, where contracts are rewritten to protect private corporations in financial distress. Mechanisms should be put in place to induce the troubled debtor to improve its capacity to pay through growth-oriented policy reform, and to encourage the banks to reduce the present value of their claims to a level that is fully serviceable.

The second principle should be one of burden-sharing. Taxpayers in the creditor governments should not bail out the banks, because banks themselves should take losses. As U.S. bank regulators have recently noted, with beefed-up equity and substantial loan-loss reserves, most banks are quite capable of absorbing major writedowns on their LDC exposure. But as a quid pro quo, the banks should receive at least partial guarantees from the public sector and regulatory reform to stretch out losses and replenish capital over time on an internationally equitable basis. The debtor country, meanwhile, must implement unpopular policies and accept greater surveillance from the international financial community.

The amount of relief should be negotiated so as to restore growth and investment and to free private banks to limit themselves to trade and low-risk project loans.

Finally, the approach should be politically feasible, administratively simple, and financially inexpensive.

Here are the key building blocks of such an approach:

- A Debt-Restructuring Advisory Committee is set up to act as a political mediator and economic adviser. Committee members are chosen from major creditor governments, the IMF, the World Bank, the regional development banks, and nongovernmental experts from the Third World. It draws on staff resources of the member multilateral institutions. (Neither the IMF nor the World Bank alone is capable of acting as an impartial mediator between the banks and the debtor seeking relief. By bringing together all the key parties involved, this approach resolves the continuing battle over whether the World Bank of the IMF should take the lead on managing the debt problem and who should guarantee the restructured debts.)

- When a middle-income debtor country decides it needs debt relief, it submits an IMF-style "letter of intent," prepared in consultation with the committee, detailing a program for policy reform supported by debt-service reduction. If the committee accepts this, it arranges negotiation with the creditor banks.

- The banks exchange their floating-rate, longer-term, public-sector loans for bonds issued by the country with long (10 to 15 years) maturities and fixed below-market rates. The spread between the market rate and coupon rate determines the implicit discount the banks offer. The bonds are at least partially guaranteed. The two most suitable candidates for guarantor are the World Bank and the IMF, with its massive gold stock, but Japan can join in with a special guarantee fund. Banks can hold these safe and marketable bonds or sell them in a secondary market to meet earnings and capital objectives.

- The amount of debt relief should be negotiated according to key criteria: restoration of reasonable growth and investment, and freeing private banks from the Ponzi trap of providing loans to finance their interest earnings. With private banks withdrawn from balance-of-payments deficits of Third World countries, the World Bank steps up structural and sectoral adjustment loans, the IMF provides loans to meet unforeseen needs, and banks limit themselves to trade and low-risk project financing.

This plan has at least three appealing features. First and most important, taxpayers will not bail out the banks, because banks will take losses. There are many ways the guarantee would be provided, but the budgetary appropriations and the potential risk to the taxpayer will be minor as the whole purpose of this restructuring is to ensure that the country has no incentive to default on its restructured debts.

Most debtor countries have tried their best to avoid defaulting on debts that they cannot service; it is hard to believe that they would default on debts that they can service. The current approach risks a bigger taxpayer bailout as the World Bank loans are used to service the banks' bad debts, the big banks clamor for "enhancement" on new money, and confrontational defaults still threaten future earnings of most of the U.S. money-center banks, and even the solvency of a few.

Second, the low-coupon bonds would

provide immediate cash-flow relief to the countries while protecting them from interest-rate risk. For the same amount of bank losses, submarket rates will permit a much bigger reduction of resource transfer than simple writedowns on principal, repayment of which has already been postponed for many years in most cases.

Fatigued Bankers

Finally, the plan would avoid the much-feared "moral hazard" problem—"bad behavior" of a debtor country is penalized. To begin with, the debt committee can reject relief for a country that pursues bad policies in order to get more relief, thus discouraging misbehavior. But more important, after relief is given, badly needed new money to finance reform and development remains conditional on carrying out those policy commitments.

Why would the banks voluntarily negotiate to write down loans on which they are currently receiving interest? One answer is that fatigued bankers may prefer a one-shot loss to disentangle themselves from the debt deadlock and avoid bigger future losses. But more important, once the official strategy of "forced lending" is abandoned, banks will negotiate because the country seeking relief will fail to remain current on interest payments. Also, once the majority of the banks sign an agreement, new legislative measures—borrowing from U.S. bankruptcy laws—can force the "free riders" to join.

Mexico is the most suitable candidate for benefiting from such an approach. It has made credible and painful efforts to adjust, its new government desperately needs debt relief to generate the political support to continue economic reform, and its economic and political stability is very much in the U.S. interest. If negotiated debt relief succeeds in jump-starting Mexico's economy, it would encourage economic reform elsewhere in the Third World, paving the way toward an effective resolution of the debt problem.

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THE AMERICAS IN 1989: Consensus for Action

A Report of the Inter-American Dialogue

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Chapter I

Debt and Stagnation: A Program for Recovery

Six years after the debt crisis began, Latin America remains mired in depression. Most Latin Americans are worse off today than they were a decade ago. Unemployment and underemployment are at record levels. Wages have declined sharply—by as much as 50 percent in some places. Average income per capita has fallen back to the level of 1978 and is not recovering.

More people than ever are trapped in extreme poverty; women and young children are suffering most. Throughout Latin America, education and health services have deteriorated; crime rates have surged; malnutrition and infant mortality are rising. Unless this depression can be ended, it will feed on itself. Continuing capital flight, low investment, rampant inflation, and erratic export prices may keep Latin America's economies stagnant well into the next decade, perhaps even beyond.

The economic crisis of the 1980s may touch off a political crisis in the 1990s. Economic adversity is already eroding the foundations of democratic rule in several countries. Public institutions have been discredited and weakened. Civilian governments, mostly headed by moderate and pragmatic leaders, have lost support and with it their capacity to govern effectively. In country after country, the hope infused by new leaders has turned to frustration as austerity has become a permanent fact of life.

The economic crisis of the 1980s may touch off a political crisis in the 1990s. In country after country, the hope infused by new leaders has turned to frustration as austerity has become a permanent fact of life

As governments lose credibility and authority, the appeal of extremist solutions grows stronger, and it becomes harder to institute the economic measures needed for recovery and growth. This vicious cycle, which is already taking hold in some countries, will not be easy to break. It may condemn Latin America to a long period of economic hardship and political turbulence. In some countries, civilian authorities may be forced to yield to military rule.

Latin America's trauma also affects the world's industrial countries—none more than the United States. U.S. banks have improved their financial positions since the early 1980s, but the debt crisis has left them weakened. The abrupt halt in Latin America's growth has cost U.S. exporters $20 to $30 billion in sales annually.

Debt is a contentious issue in U.S.-Latin American relations. The region's economic decline is straining those relations in other ways as well. Pressures for migration to the United States, for example, are greater today because so many Latin Americans are losing hope in their own economies. The Hemisphere's drug trade is more difficult to control because Latin America cannot provide alternatives to the jobs and income now derived from narcotics. And by putting the future of Latin American democracy in peril, economic paralysis could threaten hemispheric security—which is best protected by a community of democratic governments that respect one another's social and civic values. All Americans, North and South, have a joint and urgent stake in rebuilding Latin America's damaged economies.

A Gathering Consensus

Throughout the Americas, a consensus has been building on what must be done to confront Latin America's economic crisis. There is broad agreement on the need to chart a new course.

In Latin America, economic analysts from a range of perspectives—within governments and oppositions—concur, among themselves and with their foreign creditors, that new development strategies must be put in place to promote growth. They recognize the inadequacies of the state-directed, inward-oriented development policies of the past. It is widely accepted that Latin America's economies must be opened to trade and investment, and fully integrated into the world economy. Most Latin American financial authorities and political leaders also acknowledge that the state role in their economies has been excessive, and they now favor increased reliance on private markets. Although disagreements persist on precisely how to move in these directions, and at what pace, major shifts in economic thinking have taken place throughout Latin America.

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For their part, the creditor countries and banks increasingly recognize that the economies of Latin America cannot be restructured and primed for growth without substantially higher levels of external capital; that the region's capital requirements cannot be met by new lending alone; and that debt reduction is therefore essential. Latin American leaders have long called for debt reduction. Now they are being joined by commercial bankers, officials of international agencies, and financial authorities in creditor nations.

This gathering consensus provides the basis for addressing the two main obstacles to Latin America's recovery: a severe scarcity of external resources and a legacy of economic mismanagement and policy distortion.

Latin America's External Resource Gap

Latin America's economic expansion in the 1960s and 1970s was fueled by a steady flow of external capital. During the 1980s, that flow has been dramatically reversed. Between 1972 and 1981, Latin America obtained an average of some $10 billion more per year in new loans than it paid back in interest and principal. In the past six years, the region's debt payments have exceeded new lending by nearly $25 billion annually. That $35 billion a year turnabout, the equivalent of nearly $200 billion for an economy the size of the United States, is an intolerable and unsustainable drain.

The resulting scarcity of external capital has forced every Latin American country to slash imports, which are now nearly 30 percent less than they were in 1980. Much of the foregone imports are vital for production: machinery, spare parts, raw materials, and intermediate goods.

Even more troubling, investment—the key to economic growth—has fallen to dangerously low levels. In many countries, plants, machinery, and physical infrastructure are depreciating faster than they are being replaced. Just as crucial, expenditures on education and health, which are central to future productivity, have diminished sharply under austerity budgets, as has spending for scientific and technical innovation and for environmental protection. As opportunities narrow within the region, many highly skilled professionals are emigrating. Latin America is mortgaging its economic future.

Latin America is mortgaging its economic future

The region cannot meet its capital needs through new borrowing alone. Commercial creditors want to reduce, not expand, their exposure in Latin America. The major U.S. banks made this clear in mid-1987 when they set aside large reserves against Latin American loans. The region's financially-troubled debtors are not attractive borrowers. They represent a very high risk, and offer returns that are not much better than those from safer investments.

Official financing—from the World Bank, the International Monetary Fund (IMF), and the Inter-American

Latin America's Lost Decade: Some Figures

	1980	1981	1982	1983	1984	1985	1986	1987	(Est.) 1988
Real per capita GDP (% Change)	3.7	-1.9	-3.5	-4.7	1.4	1.4	1.6	0.3	-1.5
Consumer Price Level (% Change)	56	58	85	131	184	275	65	199	473
Investment (% of GDP)	23	22	21	17	17	18	18	18	18
Exports ($ Billion)	94	100	90	92	102	98	80	91.4	104.2
Imports ($ Billion)	97	105	85	64	65	63	64	71.6	77.5
External Debt ($ Billion)	231	288	333	344	362	371	382	411	413
Debt as % of Exports	183	210	273	292	277	296	351	340	309
Debt Service as % of Exports	34	42	51	40.8	40.9	40.3	45.0	35.5	42.8
Net Capital Transfers[1] ($ Billion)	12	10	-19	-32	-27	-33	-24	-21	-29

[1] New lending minus payments of interest and principal

Sources: IMF, *World Economic Outlook*, October 1988; Pedro-Pablo Kuczynski, *Latin American Debt*, 1988, ECLAC, *Preliminary Overview of the Latin American Economy*, December 1988

Development Bank (IDB)—has lagged as well. All three institutions are now collecting more on past loans than they are providing in new loans. Even with the recent $75 billion increase in the World Bank's capital, this reverse flow could persist for the next several years.

Not only is new lending not available in sufficient amounts; it may also be imprudent for Latin American countries to increase their debt burdens. By taking on new debt, the countries add further to swollen interest bills that are already overwhelming their capacity to pay. Additional loans may be simply postponing the day of reckoning—for both creditors and debtors.

The policy implications should be clear. Because Latin America's resource gap cannot be bridged by new lending, the region's current debt obligations must be reduced. This fact has become increasingly evident to creditors as well as debtors, but difficult questions remain to be faced: Whose debt obligations should be reduced? By how much? Under what conditions? Through what mechanisms? Ultimately, the question is who should bear the costs and risks.

Any debt reduction scheme would require the commercial banks to assume significant losses. Most of them are now financially better able to do so, having both reduced their Latin American exposure and created sizable reserves against anticipated losses. The banks, moreover, are willing to reduce their claims on Latin American borrowers. They are already engaging in debt-equity swaps and other limited reduction schemes. A number of prominent banking executives have publicly endorsed debt reduction as an alternative or complement to new lending.

In exchange for reducing either the interest charges or principal on their current holdings, commercial banks want to obtain at least partial guarantees that remaining claims will be paid. They are prepared to take the losses involved if, at the same time, their level of risk on the debt that would still be outstanding is diminished.

Such guarantees would have to be provided by some or all of the industrial countries. That, so far, has proved to be a crucial sticking point. Although Japan and some European countries have indicated a willingness to support such guarantees, the United States, facing its own budgetary constraints, has been opposed to committing public resources to accomplish debt reduction.

Economic Mismanagement

Latin America's economic crisis is not due to unsustainable debt alone, however. The resources available to the countries of the region have not been used very effectively.

The massive external borrowing of the 1970s both allowed for a broad expansion of government activity and shielded economies from the consequences of policy mistakes. Once that shield was stripped away, the region's poorly-managed economies were ill-prepared to respond, first to the external shocks of the early 1980s and then to an increasingly competitive international economy. Latin America has not only fallen further behind the world's industrial nations; it has been overtaken by other developing regions.

Latin America cannot hope to recover without major structural reforms. Foreign exchange must be generated and saved by promoting exports, increasing the efficiency of domestic industries, encouraging the return of flight capital, and attracting new foreign investment. Internally, fiscal deficits must be reduced, inflation brought under control, the private sector expanded and strengthened, and income and wealth more equitably distributed.

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Latin American governments have made significant adjustments in their external sectors. Realistic exchange rates are now in place in most countries, and trade deficits have been turned into surpluses—although largely by curtailing imports and real wages, not by improving productivity. More must now be done to liberalize trade policies by reducing tariffs and other import barriers.

Few governments have progressed very far in their internal reform efforts. Fiscal deficits remain all too high, causing runaway inflation in many countries, depriving the private sector of needed resources, and dampening the climate for investment. The deficits cannot be controlled as long as scarce resources are used to subsidize uncompetitive industries and finance bloated bureaucracies.

More generally, governments continue to play too large a role in Latin American economies: business and financial regulations need to be eased; markets allowed to determine most prices; and state enterprises shifted to private hands. Governments should be doing less to manage economic activities, and more to provide effective public services: education, health, social security, and infrastructural investments.

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At the same time, the main obstacles to economic reform in Latin American are neither ignorance nor lack of will. Countless reform programs have been initiated, often with the advice and supervision of the IMF and the World Bank. Most have failed to achieve very much, in good measure because they lacked adequate external support.

The capital scarcity and heavy debt burdens that have forced economic adjustment on Latin America have made that adjustment all the more difficult to accomplish. It is hard to control budget deficits when interest payments consume 25 percent or more of government expenditures. A private sector starved of capital cannot be readily transformed into a new engine of growth. Without new investments, export industries can hardly take advantage of improved trade policies.

Because capital has been short, economic reforms have often produced only transient accomplishments; sometimes they have created new problems. Devaluations, for instance, have encouraged exports, but they have also sparked inflation as the cost of imported goods rose. Raising interest rates to realistic levels has stimulated domestic savings and reduced capital flight in some countries, but it has also depressed private economic activity.

Economic reform programs, moreover, always carry very high short-term costs. When state bureaucracies are trimmed, public employees lose their jobs. Reducing subsidies—or lowering import barriers—can send marginal firms into bankruptcy, pushing more people out of work. Lifting price controls on food and other basic necessities places punishing hardships on low income groups. In Latin America, these costs have been magnified because the reforms were carried out without adequate resources. Market-oriented reforms now provoke public distrust because they have come to be associated with declining incomes, unemployment, higher prices, and deteriorating public services.

It is not enough that Latin America's financial and economic authorities agree on the need to restructure and open their economies. Democratic governments cannot establish economic policy by fiat. After so many years of decline, they cannot simply preach austerity and ignore the deprivation and anger of the poorest. They must respond to demands of labor unions, business associations, and legislatures. Unpopular policies cannot be sustained for very long.

New presidents are scheduled to take power within the next 18 months in nearly a dozen Latin American countries. The region's voters are already turning to more nationalistic leaders—as underscored by this past year's presidential elections in Mexico and Venezuela, municipal elections in Brazil, and primary voting in Argentina. The policy directions followed by the new heads of state will determine the region's economic future for years to come. Many will take office with clear mandates to reverse the economic policies of their predecessors. Regardless of the advice of economic experts, some will be less willing to persist with market reforms, and more prepared to suspend or curtail debt payments unilaterally, thus increasing the risk of confrontation between Latin American debtors and their creditors.

Latin America thus faces a second vicious cycle. Without sufficient external capital, growth-oriented economic reforms cannot take hold and produce results. But the longer such reforms are delayed, the harder it will become to generate and attract new resources. This cycle can only be broken if both obstacles are tackled together. Latin America's debt obligations must be reduced and the countries of the region must improve their economic policies. These objectives are inseparable.

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The World Economy

International economic trends, which first pushed Latin America into financial crisis six years ago, also remain a serious impediment to recovery. Every Latin

American country is highly vulnerable to developments in the world economy that are beyond its control. In the next years, the region faces three particular dangers.

First, the current expansion of the world economy, like all previous upswings, is likely to be interrupted at some point. Any marked slowdown of growth in the industrial countries would shrink Latin America's markets, exacerbating its shortage of external capital.

Second, protectionism is on the rise in the United States and elsewhere in the developed world. U.S. trade barriers have increased over the past eight years, imposing new obstacles to Latin American exports. And the pressures for greater restrictions have not abated. The limited progress made so far in the Uruguay Round of GATT negotiations offer little encouragement for a more open and vibrant world trading system. The free trade agreement between the United States and Canada, the integration of the European Economic Community, and expanding commercial relations among Asian countries all point to the possible emergence of regional trading blocs that could leave Latin America a marginal participant in international trade.

Third, international interest rates, after dropping by nearly one-half in nominal terms between 1984 and 1987, are now climbing again. For 1988, higher interest rates added more than $3 billion to Latin America's interest bill—and the IMF projects a further rise in 1989.

The United States could help to avert these dangers by dealing quickly and decisively with its fiscal and trade problems. As long as the United States continues to borrow upwards of $10 billion a month to finance its trade deficit, world interest rates will remain high. Unless the deficit is reduced soon, the risk is great that confidence in the dollar will erode, pushing interest rates higher and perhaps even plunging the United States into a recession that could spread around the industrial world. This would be a doubly cruel blow for Latin American debtors, who would then face both higher debt charges and shrinking markets.

Latin American countries must undertake severe adjustments in their economies by cutting budget deficits and balancing their external accounts—but so must the United States. This task is manageable for the United States; its fiscal deficit is only about three percent of GNP, compared to Latin American deficits that are four to five times higher. But not even the United States can succeed alone. The cooperation of Japan and Western Europe will be needed to ease current international trade and financial imbalances. All industrial countries must resist protectionism and open their markets. Only then can the world economy serve as a stimulus, rather than an obstacle, to Latin America's recovery.

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Solving the Problems

There is no easy solution to Latin America's economic problems. They derive from long-standing, deeply-embedded rigidities and distortions in the region's economies, compounded by massive debt and an adverse external environment. The obstacles to progress are daunting, particularly when so many Latin American countries are also confronting the parallel challenge of rebuilding democratic politics.

Political realities clearly must be faced, not only in Latin America but also in the United States and other industrial countries. That is why neither economic policy reform nor debt reduction can be accomplished alone. It is vital—politically as well as economically—that they proceed in tandem.

Most Latin American governments know that tough economic measures are needed, and they are willing to accept international supervision of their programs and performance. But they will face intense domestic opposition as long as such measures and the sacrifices they entail are viewed as largely benefiting external creditors rather than producing development at home. This political resistance can only be overcome if economic reforms are coupled with significant debt reduction and new capital flows, and recognized as part of a genuinely cooperative effort between debtors and creditors to promote growth.

For their part, creditor banks and countries can more readily justify the costs of helping Latin America solve its economic problems if the region's governments take the measures necessary to put their economies in order. By doing so, the debtor nations not only demonstrate their commitment to using the new resources wisely; they also reassure their creditors that they will be able to repay their remaining obligations.

A Plan of Action

Latin America must achieve growth rates in the 1990s of at least five percent per year. That is the minimum necessary to restore business confidence, improve living standards, absorb a constantly growing work force, restore social progress, and create conditions for political stability. For most countries, however, reaching this level of growth any time soon will be very difficult. It will take concerted effort from all major actors: the Latin American countries themselves, the industrial nations, the international financial institutions, and the commercial banks.

Five critical tasks must be accomplished:

- **The countries of Latin American must revamp their development strategies, restructure their economies, and effectively integrate them into the world economy;**
- **The United States must tackle its own economic problems, and join other industrial countries to reduce international financial imbalances, open world markets, and sustain world growth;**
- **The international financial institutions must sharply step up their lending to Latin America;**
- **Debt reduction agreements must be worked out between individual Latin American countries and their commercial bank creditors; and**
- **The world's industrial countries must provide appropriate financial guarantees to support debt reduction initiatives.**

The primary responsibility falls on the Latin American countries. **As an initial step, each country should formulate a comprehensive multi-year development program,** setting out realistic targets and schedules for necessary economic reforms and indicating the external capital needed to implement the reforms and achieve satisfactory growth. It is crucial that these programs be realistic. Not only must they be technically sound; they also must be politically responsive. Getting prices right is important, but so is attacking extreme poverty and economic inequities. Restoring business confidence is critical, but so is gaining the support of workers.

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The World Bank, the IMF, and the Inter-American Development Bank should, on request, help the countries prepare their development programs. The international financial institutions (IFIs) should also jointly establish procedures for reviewing the programs when they are completed, and for negotiating appropriate revisions with each country. They, too, must be sensitive to political and social questions as well as to economic criteria.

Once agreement is reached between a country and the IFIs, the resulting program would serve as the basis for subsequent financing and monitoring arrangements with both commercial and official creditors. It would provide mutually agreed-upon performance targets on which new lending and debt reduction would be conditioned.

The United States, Canada, Japan, and Western European nations should help countries gain access to the resources needed to make their economic programs work. The creditor countries should commit themselves to reducing Latin America's net capital outflow by $20 billion per year for the next several years—mainly through debt reduction and new lending from international financial institutions. By establishing and holding to this target, the industrial countries would signal their commitment to Latin America's recovery and provide the right incentive for policy reform efforts.

Another essential step for the industrial countries is to improve the financial performance of the IMF, the World Bank, and the Inter-American Development Bank. Each of these institutions must provide a substantial positive flow of capital to the region.

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- The IMF management has proposed a doubling of the Fund's basic resources, which member countries should approve. But even now, the IMF has the capacity to draw on large and currently underutilized reserves. It could as well create a new issue of special drawing rights and direct them mostly to debtor nations. The IMF could also benefit Latin America by stretching out repayment periods on new and current loans.
- The World Bank, with its recently approved $75 billion capital increase, has the means to increase disbursements sharply. It should make additional resources available by lengthening the grace period for repayment of principal on both new and existing loans. The World Bank should not set arbitrary limits on the size of its policy-based loans. These should be determined by the development needs of Latin American countries carrying out agreed economic programs.
- The United States and Latin American countries must end their damaging dispute at the Inter-American Development Bank so that the Bank can play a more significant financial role. The two-and-a-half year old dispute has stalled a scheduled $20 billion capital replenishment that would permit a near doubling of the Bank's loan commitments. The IDB should also relax, at least temporarily, its counterpart funding requirements, which have limited the disbursement of some $10 billion in committed loans.

If pushed by the industrial countries, the international financial institutions could together provide as much as $8 to $9 billion annually in additional capital to Latin America—more than 40 percent of the proposed $20 billion target. The actual financing made available to any specific country, however, would depend on its meeting the performance objectives set out in its economic program.

The most important step the industrial countries must take is to provide financial guarantees for debt reduction agreements negotiated between Latin American nations and commercial banks. Many different proposals for comprehensive debt reduction have been put forth in recent years, but none has yet gained support from either the industrial countries or the private banks—and it seems unlikely that any will, at least not soon.

The status quo is intolerable; as long as Latin America must pay out substantially more in interest than it obtains in new loans, the region will remain stuck on a tread-mill of austerity, stagnation and rising debt

But the status quo is intolerable; as long as Latin America must pay out substantially more in interest than it obtains in new loans, the region will remain stuck on a treadmill of austerity, stagnation and rising debt. What can and should be set in motion now is a step-by-step, case-by-case approach to debt reduction, in which individual countries work out specific, differentiated, and mutually-agreed arrangements with their commercial creditors.

Latin America's weakest-performing economies require outright relief from a significant share of their obligations. Bolivia has already gained significant relief from an imaginative debt buy-back scheme; with new bilateral loans, Bolivia is repurchasing its commercial debt at sharply deflated market prices. At least six other Latin American countries (Costa Rica, the Dominican Republic, Ecuador, Honduras, Nicaragua, and Peru), as well as several in the English-speaking Caribbean, are in similar economic straits from which they too need substantial relief. It no longer makes sense to maintain the fiction that they will ever pay their external obligations. The costs of debt reduction for these smaller debtors would be relatively modest. They account for less than 15 percent of all Latin American debt, and most of them are now deep in arrears.

Debt reduction will be more complicated and costly for Latin America's major debtors—Brazil, Argentina, Mexico, Chile, Venezuela, and Colombia—which together owe about 85 percent of the region's debt. But they will require proportionally smaller reductions. Indeed, for most of them, partial and temporary relief should be sufficient.

Argentina is in the most difficult bind and needs the greatest relief. Its debt is equivalent to nearly 75 percent of GNP, debt service absorbs more than 50 percent of exports, and the country is some six months behind in interest payments. In contrast, Colombia, the only country that has regularly paid both interest and principal, has an outstanding debt that is less than 20 percent of GNP, and uses only 25 percent of its exports for debt servicing. Chile has one of the highest debt to GNP ratios, but a vigorous export promotion program has reduced debt payments to 25 percent of exports. Chile and Mexico have gone furthest in reforming their economies, although Mexico and Venezuela are confronting a particularly difficult period because of low oil prices. In short, significantly different arrangements are needed for each country.

Commercial creditors will also require diverse options. Some will be prepared to sell or exchange their loans outright at a discount, while others will prefer to accept smaller interest payments. There will also be those banks, however, which will choose not to reduce their debt claims, or at least not significantly. They should be given the alternative of either making new loans or deferring interest payments. Together, the banks should offer a financial package of debt reduction and new capital sufficient to meet each country's financial requirements—provided, of course, that the country is pursuing the agreed-upon economic reforms.

The principal aim should be to secure debt reduction, not new lending, from the commercial banks

The principal aim, however, should be to secure debt reduction, not new lending, from the commercial banks. Industrial country governments should consider changes in regulatory, accounting, and tax practices that would make debt reduction more attractive. But the crucial inducement for private banks will be protection against further losses. This will require some form of official guarantees on the interest or principal that remains after the debt-reduction operation. The stronger the guarantees, the greater will be the willingness of commercial banks to reduce their claims.

The industrial countries must support the necessary guarantees, either directly or through the international financial institutions (IFIs). The actual costs involved would depend on how much of the debt is reduced, whether full or partial guarantees are provided, and whether the guarantees are ever called. Since the banks would assume the up front losses, the initial costs to the industrial countries or IFIs would be modest; they would, however, be required to shoulder the risk of nonpayment on still-outstanding claims. That risk would be small if, as proposed, the relief is granted only to those countries committed to economic reform. If the amount of reduction and new lending offered the countries is adequate to meet their growth needs, they will then be in position to repay their remaining obligations.

Ideally, all of the major creditor nations would join together to back the guarantees needed for a debt reduction program. Yet the program should not be delayed until such a broad agreement is reached. Some countries, notably the United States, face economic and political constraints that may prevent their joining fully at the outset. A significant debt reduction program, however, could be launched by Japan and the trade surplus countries of Europe. Instead of spurning Japanese and European initiatives, as it has to date, the United States should be actively encouraging these offers. Japan on its own could set debt reduction negotiations in motion with a modest contribution to the World Bank or IMF to establish a guarantee fund for commercial creditors. Such a fund would likely then attract other donors.

Taking the Initiative

Latin America's economic crisis can be resolved—but substantial changes must be made in the policies and strategies that have been followed to date. Broad agreement exists on what needs to be done. The largest part of the burden will fall on Latin American countries. They have to restructure their economies in the face of formidable economic obstacles and immense political resistance—but they can only succeed if they have access to adequate external capital.

The United States has an indispensable part to play. It should cooperate with other industrial countries to enhance the role of the international financial institutions and significantly expand their net lending to the region. The new U.S. Administration and Congress must also support efforts to reduce Latin America's debt obligations. Washington should strongly encourage U.S. banks to negotiate debt reduction agreements with Latin American countries, and join with other creditor nations to mobilize the financial backing to make debt reduction work.

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The longer decisive action to reduce Latin America's debt burden is put off, the greater the costs will ultimately be—for the United States as well as Latin America. The sooner action is taken, the easier it will be for the United States and Latin America to cooperate effectively on the other shared problems they face. There is no excuse for delay.

4. Third World Debt and International Trade

Trade and the related issue of third-world debt can no longer be relegated to technicians. Both are, in our opinion, Presidential level issues and should be treated as such throughout your Presidency. They will require your personal attention, resources, and deserve high priority on your agenda.

Despite some improvement, our trade deficit remains high, unacceptably high, a symbol of our lack of international competitiveness and a reflection of our budget deficit.

Trade is no longer an arcane economic issue; it has profound foreign policy impacts. Trade frictions with our allies can weaken our alliances. New challenges lie ahead, such as the creation of a Single Market in 1992 for the European Community, the world's largest trading block, which must not be turned into a protectionist market against U.S. products.

So, too, Third World debt is not simply an issue for commercial banks holding huge unpaid and unpayable loans. Debt cripples growth in Latin America and in the developing world, with a consequent drop in their purchases of American goods.

The U.S. trade deficit will remain high so long as demand is depressed in the Third World by their huge debt obligation. Third World debt, like trade, has far-reaching political ramifications; it is weakening moderate democratic forces in Mexico, Brazil, Argentina and other countries, and strengthening opposition leaders with radical approaches to the debt issue and overall relations with the United States.

Trade. The imperatives of the calendar require early decisions and actions. The Uruguay Round of Trade Negotiations is entering an important stage with a December mid-term review and will present major challenges to the U.S.; a series of major sectoral decisions must be taken, beginning in 1989 with steel; several rescheduling negotiations, notably Argentina, will come to a head in early 1989; and there is a Seven Nation Economic Summit in June 1989.

We recommend that you:

- **during the transition choose a U.S. Trade Representative of significant political stature who is respected on Capitol Hill and credible to the U.S. private sector, provide him or her direct access to you, and include your USTR in all major trade discussions with foreign leaders.**
- **work with President Reagan's representatives to issue a strong statement in support of the bipartisan goals of the U.S. in the Uruguay Round, during the mid-term December review in Montreal.**
- **direct your USTR to place a priority on developing a code of services, meaningful intellectual property protection, clear rules for U.S. foreign investment abroad, a reduction in agricultural subsidies, and strengthened GATT dispute resolution procedures.**
- **articulate an American trade policy that places primary emphasis on multilateral negotiations. But where multilateral progress cannot be made, negotiations should proceed among small groups of like-minded nations within the Uruguay Round or toward bilateral agreements modeled after the U.S.-Canada and U.S.-Israel Free Trade Agreements.**

- **take a few early actions under the new 1988 Trade Act to establish the credibility of American fair trade policy by using the threat of retaliation in particularly blatant cases of truly unfair trade practices.**
- **work with the European Community to assure that the creation of their Single Market does not create further barriers to trade.**
- **appoint a more permanent group of "wise men" or develop a high level forum at the ministerial level with Japan which will lead to a comprehensive approach to anticipate and head off troublesome issues, and to avoid frequent confrontations with Japan over trade at a time when we need their financial resources to help with Third World economic development and debt relief.**

Third World Debt. We also believe rapid action will be needed to develop a strategy on Third World debt. Despite six years of U.S. economic growth and lower domestic interest rates, real interest rates are the highest ever; and third-world debt has not eased and, for most nations, has worsened—measured by the ratio of debt to GNP. The Baker Plan helped avoid a crisis but we believe that events have passed it by and a new direction is needed, using it as a point of departure. The longer the problem continues, the greater the chance one of the big Latin American debtors will suffer a social, political, or economic crisis.

We recommend you direct your new Treasury Secretary, in consultation with your Secretary of State, private banks and with the major multilateral institutions, to develop an approach to the third-world debt problem by the time of the June Economic Summit.

A Japanese plan has already been developed and it is important that the U.S. retain the lead.

The new Omnibus Trade Act calls for the Treasury Secretary, the Federal Reserve and others to respond with a plan in 1989, with the first deadline in February for an interim report to Congress. In anticipation of that, we believe you should direct the Secretary of the Treasury to accelerate U.S. leadership in concert with the G-7 governments and the world banking and trade institutions (including GATT) to develop additional ideas and approaches for dealing with the very serious problems of Third World debt, with the goals of reversing outflows of financial resources from the very countries that most need capital for their development, and accelerating the overall growth of world trade.

There are several possible solutions in addition to the more active use of traditional techniques, including: an international agency to buy third-world debt from the banks at a discount; an IMF trust to hold industrial nation bonds deposited by debtor nations to collateralize a new issue of their own bonds which would be swapped at a discount for their existing bank debt; debtor nations could exchange newly issued bonds for bank loans; a fund to cap interest payments could be created; debtor nations could be allowed to make debt payments in local currencies which banks could not repatriate for several years, the World Bank could make guarantees of a portion of interest payments on new loans or bonds.

Whichever solution is chosen, we recommend it should be based on the following principles:

- **It should lead to a reduction of the net outflow of capital from Third World countries. In 1980 there was a $35 billion annual net transfer of funds from rich to poor nations. Now there is a $30 billion annual net transfer from poor to rich nations.**
- **Costs and benefits must be shared among debtor nations, banks, and industrial countries, with nations like Japan fully enlisted to provide their resources.**
- **Case-by-case arrangements should be tailored to the circumstances of particular debtor nations.**
- **The U.S. should support active roles for the World Bank, IMF, and regional development banks.**
- **Any new financial instruments created in exchange for debt should be liquid and negotiable.**
- **Debtor nations should be encouraged, by incentives and penalties, to undertake growth and efficiency-oriented reforms. At the same time debt relief and new loans should be used to encourage Third World countries to protect and not destroy their rain forests and other environmental resources.**
- **Distinctions should be made between the poorest nations, advanced nations with inadequate domestic policies, and advanced countries with currently sound fiscal programs.**

Acting promptly on trade and third-world debt can avoid manageable problems becoming unmanageable ones later in your term.

It is time for a major new effort to resolve the international debt problem.

The heavy indebtedness of many developing countries—especially Mexico, Brazil, and Argentina—poses a continuing threat to the world financial system and to Third World growth and political stability. The United States has an especially high stake in finding a solution, given the major role of U.S. banks and the special importance of Latin America to our economy and our security. Slow growth in Latin America has had a serious negative impact on U.S. exports.

The seventeen most heavily indebted countries—twelve are in Latin America—owed about $485 billion at the end of 1987. These countries as a group have made considerable economic progress in the last several years, growing at a real annual rate of about 3 percent in 1985-87, instituting austerity programs and increasing their exports. But debt service remains a heavy burden, continued outflow of financial resources threatens their future growth, and austerity is painful when incomes are already low. Failure to resolve the debt problem could damage the cause of democracy in this hemisphere, risking the return to power of repressive regimes and hampering solution of serious common problems, such as drug traffic.

The Baker Plan bought time for negotiation and internal reforms, but the new bank lending envisioned by the Plan has not occurred. It is time for another major step toward a long-run solution.

The problem is complex and no simple solutions exist. Plans abound. We believe a strategy for LDC debt and economic development should:

- continue to require country-by-country negotiations and solutions appropriate to each;
- provide incentives for policy reform conducive to sustained economic growth in debtor countries;
- insure an adequate amount of financial support—either new lending or negotiated debt relief—from banks in developed countries, developed country governments, and from multilateral institutions; and
- include contingent financial backing from the developed country governments to encourage adequate financial relief for the banks and to bolster economic reform commitments by the debtor countries.

We urge you to assign a high-level group—including the State Department and the Treasury Department—to evaluate economic and political conditions in the less developed countries and recommend the best course of action for addressing the linked problems of debt and economic development. The requirements of the Omnibus Trade Act of 1988, the likelihood of new initiatives at the G-7 Economic Summit in June, and the possibility of a sudden crisis involving one or more debtor countries are all reasons for urgency in developing your long-term strategy. Your taking the initiative on new solutions to the debt and development problem would be a major plus for U.S. leadership and influence in the world.

The crisis in the thrift industry should be resolved quickly.

Serious problems in the savings and loan industry should be addressed rapidly, since delay will raise the ultimate cost to the taxpayer. It is estimated that at least five hundred saving and loan associations are insolvent under generally accepted accounting principles and another 400 or more are in danger of failure. Problem thrifts are concentrated in Texas and the Southwest, but exist in many other states as well.

The fact that deposits in thrift institutions are insured up to $100,000 by the Federal Savings and Loan Corporation (FSLIC) makes the thrift crisis a federal government problem and also creates the need for speedy action to minimize the eventual cost. Insolvent thrift institutions which are allowed to continue operating have an incentive to attract additional insured deposits by offering above market interest rates and making high risk loans. This behavior raises the cost of funds to healthy thrifts, as well as to banks, and increases the liability of FSLIC when the insolvent thrifts eventually go under. Hence, we urge you to move quickly to reach agreement with Congress on a plan to close all insolvent thrifts or merge them into healthier institutions willing to contribute additional capital.

The federal cost will be substantial. Guesses about the difference between the deposit liabilities of insolvent thrifts and the market value of their assets range from about $50 billion to over $100 billion—far beyond current and prospective resources of FSLIC. The costs can be spread over time and at least initially handled outside the purview of Gramm-Rudman-Hollings by having an off-budget agency issue long-term bonds. However, this borrowing would still add to federal dissaving and to current interest costs.

Alternative rescue plans are discussed further in an appendix. **We urge you to work with Congress to choose a plan which:**

- **reduces excess capacity in the thrift industry by closing institutions for which no substantial new private investment can be found;**
- **shares costs equitably among the banking and thrift industries and the taxpayer;**
- **is consistent with a longer term strategy for erasing the distinction between banks and thrifts and restructuring the entire financial services industry;**
- **is capable of being implemented rapidly.**

If swift action is taken, the savings and loan crisis need not develop into a major threat to the financial system.

Conclusion

The next decade will be crucial for the US economy. If we continue to consume beyond our means and allow productivity to lag, we risk eroding our standard of living and sliding slowly out of the front ranks of economic powers. But if we act wisely—saving out of current income and making the human, intellectual and physical investments necessary to accelerate future productivity growth—the US can continue to enjoy domestic prosperity and a leadership position along with Japan and the European Economic Community, in an expanding world economy.

Third World Debt

Robert D. Hormats

I. Statement of the Problem

Heavy debt has slowed economic growth and halted investment in many developing nations, and contributed to a sharp drop in their imports from the U.S. As a result, a large number of American jobs have been lost.

Debt-induced declines in living standards have greatly weakened public support in third world countries for moderate, market-oriented governments and strengthened opposition leaders demanding a more radical approach to the debt issue, and have contributed to overall declining relations with the U.S.

While the current U.S. debt strategy has had some success, it has not yet restored major debtors to prosperity or creditworthiness. And the situation could deteriorate should U.S. growth slow, interest rates rise significantly, or Third World nations lose heart and abandon current restructuring measures.

A serious crisis could occur due to an inability of a large Third World nation to service its debt or political turmoil leading to its unwillingness to do so. This could happen early in 1989—even before a new Administration has worked out its overall strategy for dealing with the debt problem.

II. Background

The Third World debt problem can be attributed in large measure to the big rise in world interest rates in the early 1980s. The interest expense on the external debt of the four biggest debtors (Argentina, Brazil, Mexico and Venezuela) tripled from 1979 to 1982, from $11 billion to $33 billion. Many Third World nations overborrowed when interest rates were low and in numerous instances used the "cheap" funds to prop up overvalued currencies, subsidize inefficient government-owned companies, or avoid cuts in bloated government budgets—so that much of the money borrowed did not generate capacity to earn the funds with which to service it.

On the other side of the coin, banks overlent—often with less than adequate information about the debt exposure of individual nations—as a result of the need to recycle OPEC deposits, which the government had been reluctant to do, and the banks' own competition with one another to increase market share.

Much LDC borrowing and bank lending was based on the assumption of continued inflation—*i.e.*, that commodity prices would rise further so that debt could easily be repaid with higher earnings and in cheaper dollars. But recession in the industrialized world led to a sharp curtailment of the volume of its imports from LDCs, and a drop in commodity prices, which in turn, slashed LDC export earnings. The recession did not, however, lower interest rates significantly; the real cost of money stayed quite high—raising the cost of refinancing old debt.

Between 1979 and 1983, the big four debtors suffered capital outflow of $94 billion, about 63% of the overall deterioration in their external debt. This reflected a lack of confidence by their own citizens in their domestic policies and future political

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stability; high U.S. interest rates and the attractiveness of the American safe haven were also factors.

Despite six years of U.S. economic expansion, the Third World debt problem has eased only slightly. On the positive side, growth is somewhat higher and payments moratoria have become an increasingly unattractive alternative; Brazil has revoked it's moratorium and Peru's has proved costly. In some cases, however, the situation is worse. The ratio of interest payments to exports has fallen since 1982—thanks in part to a fall in interest rates—but the critical ratio of debt to GNP in most nations is higher. And for the 15 "highly indebted" nations, whose debts are mostly owed to commercial banks, growth has returned but GNP per capita is still below the 1980 level. Nine have had real growth declines in at least one year since 1982, and in three real income per capita has fallen every year. In sub-Saharan Africa, real per capital income has fallen in almost every year since 1980 and is about 14 percent lower than in 1980.

The Baker Plan—which sought to address the problems of the 15 biggest debtors—envisaged that a combination of market-oriented, growth-producing policies by the debtors themselves, supported by new lending from the commercial banks and additional assistance from the World Bank and IMF, would permit a gradual amelioration of the debt problem and increased economic activity in the debtors. But the high-debt LDCs have had only modest incentives to pursue prudent economic policies, and commercial banks have seen little reason to extend new loans. Although the banks are extending some new funds in conjunction with reschedulings, they are reluctant to make new loans on a large scale, arguing that they need to strengthen their capital base, that arrearages make new loans unappealing, and that they are generally overexposed to the restructuring countries.

A great many solutions have been proposed, most of which fall within the following seven approaches. Unlike the Baker Plan—which was predicated on the notion that no public funds or guarantees would be made available to take over commercial risk—some of these proposals rely on public capital or guarantees:

- **More actively utilize traditional techniques such as those incorporated in the recent Brazil rescheduling package which, as the first combine substantial new money with major debt reduction, could point the way to future such agreements; these techniques include a stretching out of repayments, reduced interest spreads, co-financing and parallel lending with the World Bank, provision of "exit bond" options to enable banks to sell existing debt at a discount, expanded use of debt-to-equity swaps, and relending.**
- **Exchange bank loans for new bonds issued by debtor countries. Concessions on interest or principal would be negotiated, some form of credit enhancement on the new bonds would be provided by industrialized nations or international institutions. The bonds might also be collateralized by zero-coupon bonds issued by the G-7 countries and bought by the individual LDC, or in its behalf by the World Bank.**
- **Establish, in the IMF, a trust to hold industrialized-nation bonds brought, and then deposited there, by indebted nations to collateralize a new issue of their own bonds. Such bonds would be swapped at a discount for their existing bank debt. Indebted nations would also put aside a portion of their foreign exchange earnings to ensure repayment of interest on rescheduled bank loans.**

- **Encourage banks to reduce interest rates on LDC loans for a period of time by setting up insurance for the remaining interest payments. Banks would pay premiums or fund an initial insurance pool, with industrial nation governments providing contingent support.**
- **Set up an agency sponsored by industrialized country governments to buy debt from banks at a discount. One proposal would establish a facility to negotiate debt restructuring packages in exchange for broader structural adjustment by the debtors. Secured notes would be exchanged for bank loans at a discount, thus providing debt relief on those loans and leaving the banks with a more secure instrument. Industrialized country governments would provide the agency with capital and standby guarantees to ensure its ability to sell its own debt in order to obtain the backup resources.**
- **Allow LDCs to make debt service payments in local currencies; banks would undertake not to repatriate the local currency for several years. One such proposal would couple bank agreement to accept local currencies with the requirement that the LDC run a balanced budget.**
- **Secure guarantees by the World Bank or creditor governments of a portion of interest payments on new loans or bonds; or the Bank would provide financial arrangements that make a default against the private lender tantamount to a default against the Bank.**

II. Magnitude and Urgency of the Problem

There is a possibility of getting through the next few years without a major default or a severe deterioration in social stability in a major debtor nation. But there is also a risk—which grows larger the longer the problem continues—that one or more of the big debtors will suffer a social or economic crisis. If the country in question were Mexico, the exodus of people and the pervasive instability that could result would have very direct social, political and security implications for the U.S.

Even if there is no crisis, the debt constraints of these countries will continue to retard their growth. For the U.S., that portends a continued weakness in a formerly vigorous market for U.S. exports. Politically, the cause of democracy in the hemisphere could suffer a severe setback, risking a return to power of repressive or anti-American governments.

Today the big three debtors have more debt than in 1982: Brazil, $120 billion; Mexico, $107 billion; and Argentina, $62 billion. Powerful political leaders continue to urge radical solutions. In the Mexican elections, opposition candidate Cuauhtemoc Cardenas placed a strong second; he had argued that onerous debt payments under the PRI government were the cause of Mexico's stagnation. Peronist leader Carlos Saul Menem in Argentina, Venezuela's Carlos Andres Peres, and Brazil's Lionel Brizola, all strong presidential possibilities, are basing their campaigns on the message that debt service condemns their countries to misery; some have threatened to terminate all or a portion of debt service payments.

III. Recommendations for U.S. Policy

A. Direct the Secretary of Treasury to develop a third world debt initiative by July 1989. It would be unnecessary and unwise to endorse a specific debt plan at the outset of the next Administration. But because of the importance of the issue, the next Administration should aim to have a new set of initiatives ready before the next Seven

Nation Economic Summit to be held in France in July. A coalition of industrialized nations could put the subject on a positive track at that time. In any case, the 1988 Trade Act requires the next Administration to examine this issue and provide Congress with a report on the feasibility of establishing a new debt management authority.

A workable plan for reducing the debt burden probably requires an approach based on the following features:

- **Arrangements with debtors should be on a case-by-case basis.**
- **Industrial nations should more actively support adequate funding for the World Bank, Inter-American Development Bank, African Development Bank and IMF, thereby enabling such organizations to provide new money in support of sound development projects or plans.**
- **Any new financial instruments created in exchange for debt should be liquid and negotiable, thus enabling holdings of LDC debt to be broadened and purchases should not be mandatory.**
- **Incentives and penalties should be provided to encourage LDCs to undertake growth, and efficiency oriented reforms; financial support must be linked to sound reforms in order to work.**
- **Agreements should be compatible with early resumption of voluntary lending (*i.e.*, avoid one time solutions that would discourage new private lending), because the prospect of new lending provides an incentive for LDCs to follow sound domestic policies.**
- **Any new plan should lead to a reduction of the currently large net outflow of capital from the LDCs to their collective creditors.**
- **Proposals that call for new loans by one group simply to enable another to get repaid should be avoided; such schemes will not command political support.**
- **Plans should distinguish between the indebted nations which have not undertaken adequate domestic policy reforms (which should not be given support other than essential rescheduling), and nations whose domestic policies are sound (which warrant special encouragement from the international community).**
- **New approaches should marshal the formidable resources of the big capital exporting industrialized nations, such as Japan.**

In developing a new initiative, the Administration should involve affected countries, government agencies, and banks. Care should be taken to avoid raising excessively optimistic expectations in debtor nations, lest they anticipate major changes in policy beneficial to them and become unwilling to negotiate new reschedulings, or continue their current economic restructuring programs, in anticipation of a better deal.

B. Direct the Treasury Secretary-designate to prepare a debt crisis contingency plan. The next Administration should be alert to the possibility that a crisis may emerge in a debtor nation before the long-term strategy addressed above has been developed. Such a crisis could be precipitated by the election of a government which renounces its debt, or by the breakdown of relations with the lender banks themselves. The rescheduling negotiations with Argentina, for example, will come to a head in late 1988 or early 1989.

In such an eventuality, short-term, *ad hoc*, measures may be required. The new Administration should develop measures to cope with an emergency, but should make it clear that such measures should not be seen as thereby setting a precedent for its longer term debt strategy.

THE INSTITUTE OF INTERNATIONAL FINANCE, INC.

THE WAY FORWARD FOR MIDDLE-INCOME COUNTRIES

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EXECUTIVE SUMMARY

Substantial progress has been achieved over the past six years by the middle-income countries which became the focus of Secretary Baker's Plan in 1985. Current account deficits have been curtailed; export volumes have risen; the need for structural reform and liberalization has been recognized. There is renewed awareness that confrontation is not a viable strategy.

Much remains to be done, however. Brisker growth is needed in major countries; hyperinflation must be tackled; capital flight needs to be reversed; structural reform and liberalization must be accelerated. It is vital that money continues to flow to those countries that are making the necessary economic adjustments. These countries, their bankers, creditor governments and the multilateral lenders must build upon the Baker Plan to forge a viable strategy for growth and development.

Banks have been innovative in responding to the financing needs of the debtors. Banks believe further progress can be made, partly through new money packages with an expanded menu of options and appropriate incentives, and partly through voluntary debt reduction which cuts external debt servicing costs and improves the quality of the remaining debt. Banks will also consider, under appropriate terms, multi-year commitments as part of a coordinated process with the IMF and the World Bank to extend the financing horizon.

Baker Plan Countries

Growth and development in the Baker Plan countries require ongoing policy reforms supported by continued capital inflows from abroad. These countries' policies are the key to future growth and creditworthiness. The successes and failures of the past three years indicate where major weaknesses exist and what has to be changed to accelerate progress towards solving the twin problems of external debt and development.

Baker Plan countries have no choice but to reform their economic policies. Their economies need more effective incentives through appropriate pricing and investment policies, opening up their economies to external competition and removing constraints on the private sector.

- Brazil, Chile and Mexico, by easing restrictions on investment from abroad and leaving the private sector free to negotiate, have been able to restructure and recapitalize key industries.
- The experience in Brazil has demonstrated that new money and debt reduction can go hand in hand when debt reduction is a voluntary option and the ability to make equity investments is attractive and relatively unconstrained.
- Discussion of the scope for restoring growth in the Baker Plan countries often neglects their considerable assets and the potential benefit of attracting back flight capital. While precise figures are difficult to obtain, the IMF estimates that the external assets of all capital-exporting developing

countries at the end of 1985 were about $500 billion, or one half their external debt.

Commercial Banks

The long-term interests of middle-income countries and their international banks are interdependent. Because of this, banks recognize the continued need for both new money and voluntary debt conversion and reduction. Both are possible under conditions which meet the test of bankable business.

Since 1982, banks have agreed to postpone repayment of principal on loans totaling $395 billion, to maintain $24 billion in short-term trade and interbank lines, and to provide $50 billion in new money commitments to the Baker 15. Banks have also lowered fees and interest rate spreads and extended grace periods and maturity dates. But as responsive as banks have been, they are now facing growing strains, and actions are needed to ensure that they will be able to continue to play a constructive and effective role in financing growth and development.

Banks' attitudes towards new lending to the Baker 15 have been adversely affected by inconsistent policy performance by the majority of the countries and frequent accumulation of interest arrears. In addition, the need to increase loan loss provisions and improve capital strength as well as changing business strategies and greater differences among national banking groups have contributed to the erosion of the base for concerted lending. These developments place an increasingly heavy burden on banks that remain in the concerted lending process and threaten to bring it down.

Banks need a new rationale to stay in the process. This entails first of all a continued commitment to the cooperative, concerted, case-by-case approach. Creditor governments must support debtor governments willing to undertake suitable reforms, both directly and through the international financial institutions. Official creditors must provide increasing shares of general purpose financing as bank lending moves from balance of payments financing back to transactional and investment finance. The scope for voluntary debt reduction must be significantly enlarged, mostly through appropriate actions by the debtor countries that attract equity investments. Banks must develop on a case-by-case basis an expanding menu of options and incentives that will permit individual banks to pursue alternatives that are in conformity with their own circumstances and yet continue to participate in a meaningful manner in new money packages. Where appropriate, creditor countries and international financial institutions must provide credit enhancement for commercial bank packages.

But the concerted lending process also needs reinforcement from the perspective of debtor countries. Thus, as part of the strategy of redirecting their lending, banks will consider multi-year financing commitments, in the context of an expanded menu of options and incentives, to support economic growth when there are productive investments to be financed. Such commitments would have to be linked to similar multi-year commitments and adequate flows of funds from the IMF and the World Bank. They would also be conditional on debtor governments continuing to implement development strategies that give priority to the private sector.

Debt Forgiveness

Debt forgiveness — that is, any mandatory debt cancellation scheme — is not in the best interest of the middle-income countries. It cannot be a part of the new rationale needed for banks. Such schemes are politically and administratively impractical as well as inequitable. Moreover, they would be self-defeating since they would choke off future capital flows from private sources and make the middle-income countries, like the poorest of the low-income countries, dependent on foreign aid and therefore on the taxpayers in the industrial countries. And without access to foreign private capital and technology these countries are unlikely to be able to hold their own in an increasingly competitive world economy.

- Some observers have read bank provisioning as a signal of ability and willingness to write off sovereign debt and even to forgive it outright. This is a very serious misunderstanding. Bank provisioning is reflective of prudence and conservative accounting; it does not free borrowers from their contractual obligations to service debt or banks from their fiduciary obligation to collect it.

Voluntary Debt Reduction

Voluntary debt reduction is an entirely different matter. The last two years have seen expanding use of innovative, voluntary and market-based financial techniques which reduce the outstanding external bank debts and debt service obligations of Baker Plan countries. The total reduction in the external debt of these countries brought about in this way already exceeds $26 billion and approaches almost 10 percent of the bank debt. The main vehicles have been debt-for-equity and local currency conversions and private sector restructuring. The reduction in bank debt has been significant for several countries; in Chile, for example, cumulative bank debt reduction amounts to over 36 percent.

Creditor Countries

Governments of the creditor countries share the responsibility for the resolution of the problems of the Baker Plan countries. They need to moderate inflationary trends, remove trade barriers, and devise a regulatory and tax environment that is more conducive to private lending to middle-income countries. They must also provide more direct financial support through their export credit agencies and Paris Club rescheduling. Such policies are in the economic self-interest of the industrial countries but, more importantly, they also serve their geopolitical interests.

Creditor governments should also seek other ways in which they (or the international financial institutions) could encourage banks to make new loans and accelerate the application of voluntary, market-oriented financing techniques that reduce existing bank debt. Providing guarantees as to interest and/or principal would be one way of doing so, both with regard to new loans and debt conversions. To the extent that creditor governments (or the international financial institutions) provide such credit enhancement, it should be structured and utilized on a case-by-case basis in the manner which will best facilitate a particular debtor country's regaining access to the global capital market.

International Financial Institutions

The IMF and the World Bank need to play a strong and expanded role. Firm conditionality must be an integral part of their assistance. The IMF should provide expanded and more predictable lending to the Baker 15, thereby encouraging debtor governments to adopt better macroeconomic policies and structural reforms and providing linkage for participation by commercial banks.

The World Bank should increase its own disbursements and provide banks with better cofinancing opportunities. It could also provide, on a selective basis, enhancements for voluntary debt reduction programs. The roles of the IFC and MIGA should be expanded to give more support to private investment flows. The IDB must again become a meaningful source of development finance.

The Way Forward

The way forward for middle-income countries must lead to restoring market access. In mid-1987, the Institute issued a report entitled "Restoring Market Access: New Directions in Bank Lending" which elaborated the banks' views on ways to achieve this objective. The key message of that report remains unchanged: Responsibility for regaining market access rests first and foremost with the debtor countries and depends on their economic policies. Fundamentally, the middle-income countries can only achieve their growth aspirations if they are willing to pursue policies that provide reasonable prospects for a restoration of investor confidence inside and outside their borders. The Institute and its members are prepared to collaborate constructively with creditor governments and the international financial institutions to assist the debtor countries in regaining market access.

Major efforts have been made since 1982 to respond in a cooperative and concerted fashion to the problems faced by heavily indebted, middle-income countries. Each year has seen changed circumstances and responses as the longer-term and complex implications for economic growth and development have become evident.

Baker Plan has provided working basis for concerted, case-by-case efforts . . .

In 1985, the former U.S. Secretary of the Treasury Baker proposed a strategy to support structural adjustment and economic growth, concentrating on 15 countries, now known as the Baker Plan countries or the Baker 15[1]. To achieve growth, these countries would undertake broadscale and far-reaching structural reform. External creditors would provide continued finance. The principles of the strategy were accepted by all parties and became the working basis for concerted case-by-case efforts.

. . . but Brazilian moratorium posed a major challenge for cooperative approach

In February 1987, Brazil ceased paying interest on its medium- and long-term external bank debt. To many, this signaled a shift from cooperation to confrontation. In the event, the moratorium proved costly both for Brazil and its creditors. Brazil's economy did not grow faster, investment declined, reserves did not increase, trade and interbank lines were reduced, capital flight accelerated, and public finances deteriorated. Banks reassessed their provisioning policies, with major U.S., U.K. and Canadian banks increasing their loan loss provisions. In September 1987, Brazil resumed formal negotiations with its bank creditors. Since then, Brazil has cleared its arrears, concluded a major new financing package and normalized relations with its official and private creditors.

Confrontation not a viable strategy

In retrospect, it is clear that Brazil's unilateral action was a watershed event. It proved that confrontation is not a viable strategy for debtor countries to follow. It demonstrated the need for a cooperative approach. But at the same time it has adversely affected banks' willingness to make new loans to troubled debtor countries. Higher reserves, however, have given banks additional flexibility in managing their portfolios. As a result, there has been a substantial increase in the volume of voluntary debt conversions.

Need to reassess role of debtors and creditors

It is essential that these interdependent developments be taken into account as all parties consider how the Baker 15 can accelerate growth and development and, ultimately, restore market access. This will necessarily entail a reassessment of the respective roles of debtor countries, banks, creditor governments and international financial institutions. The purpose of this report is to put forward the Institute's views on these roles.

Section II notes the improvements in the external accounts of the Baker Plan countries. Domestic performance, however, has been more uneven. Countries where inflation is rampant and growth low have to commit themselves to sound economic policies and far more comprehensive structural reform and liberalization than seen to date.

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[1] The Baker Plan countries are: Argentina, Bolivia, Brazil, Chile, Colombia, Cote d'Ivoire, Ecuador, Mexico, Morocco, Peru, the Philippines, Nigeria, Uruguay, Venezuela and Yugoslavia.

Section III starts with an analysis of recent trends in bank lending to the Baker 15. It then focuses on the factors affecting banks' attitudes and lending practices. The section concludes with a discussion of the actions needed to maintain the concerted lending process.

Section IV shows why generalized and mandatory debt forgiveness is a defeatist strategy.

Section V makes the case for voluntary debt conversion and debt service reduction. It documents the expanding use of innovative, voluntary and market-based financial techniques in recent years and gauges their future potential.

Section VI discusses how creditor country governments can help the Baker Plan countries, both through better macropolicies and more forthcoming micropolicies.

Finally, Section VII addresses the role of the international financial institutions, particularly the IMF and the World Bank.

Debtor countries, their bankers, creditor governments and multilateral lenders must forge a viable strategy for growth and development

The conclusion is that growth can be accelerated through improved policies in debtor countries, particularly those which open the economy to the stimulus of international competition and encourage private sector initiative. External finances also can be managed in such a way that economic incentives are kept right and long-term access to financial markets is eventually restored. Banks are prepared to continue to participate in new money packages that support growth and that contain transactional and investment financing options and appropriate incentives — provided they are joined by official creditors and debtor countries' policies are focused on structural reform and liberalization. Progress can be made through expanded use of markets to reduce debt voluntarily as has been occurring at a rapid pace during the past two years. Governments of the creditor countries and the international financial institutions share in the responsibility for the resolution of the problems of the Baker Plan countries and need to provide more financial support. All of the above are essential elements of a successful strategy to deal with the twin problems of debt and development. Conversely, debt forgiveness — that is, mandatory debt cancellation schemes — is not the answer to the development problem of the middle-income countries.

Growth performance has been mixed

Growth in Baker Plan countries has been constrained by the need to curtail the excessive balance of payments deficits of the early 1980s. Some countries, e.g., Chile, Colombia, Morocco and the Philippines, have in recent years achieved annual growth of 5 to 6 percent with moderate inflation and improved current accounts. Governments have been successful in improving their trade balances when they combined adequate exchange rates with domestic restraint so that exporters were attracted to foreign markets. But the record of growth of less than 2 percent over the last two years for Argentina, Brazil, Mexico, Nigeria and Yugoslavia is far below the potential growth capacity of these economies. It is clear that these countries must find ways to combine brisker growth with stronger external positions.

Hyperinflation imperils progress

Rapid inflation has been a characteristic of many of the Baker Plan countries, and in some countries has approached hyperinflation levels. Cumulative inflation from 1982 to 1988 amounts to 475,000 percent for Argentina; 120,000 percent for Brazil; 29,000 percent for Peru and 5,000 percent for Mexico. Rapid inflation distorts investment decisions, incentives for saving, and income distribution, and complicates the implementation of macroeconomic policies. Moreover, it stimulates flight from domestic to foreign assets. Rapid inflation is inconsistent with the sustained growth and development strategy that is needed for strengthening the external accounts.

Capital flight persists

Balance of payments problems have been further exacerbated by the persistent problem of capital flight. Because residents of these countries lack confidence in the policies of their own governments, they have moved substantial amounts of their assets abroad, where they are safe from the ravages of inflation. For example, the IMF has put the external assets of all capital-importing developing countries per end-1985 at some $500 billion, of which only $150 billion was accounted for by official reserves; this compares with an estimate of the total external debt of these countries at end-1985 of some $1,000 billion.

Assets of debtor countries amount to 45 percent of external debt

The IMF's concept of capital-importing developing countries obviously covers not only the Baker Plan countries but others as well. While the IMF has not published estimates for the Baker Plan countries, it estimates that the external assets of countries with recent debt servicing problems, a somewhat larger group, averaged 45 percent of their external debt at end-1985. Discussion of the scope for restoring growth in the Baker Plan countries all too often neglects the considerable assets of these countries, both external and internal. This is tantamount to discussing the liabilities of an ongoing concern without any regard to net worth and productive capacity.

Lasting improvements in the external accounts will not occur until countries achieve sustained economic growth and structural reforms provide the right incentives for longer-term development. Since growth depends on an increase in productive investment, policies are needed to encourage increases in domestic savings and repatriation of capital, and to stimulate inflows of foreign capital to supplement domestic sources of funds.

Policies needed to achieve strategic objectives can be mutually reinforcing

Governments must strive to achieve three strategic objectives: they must stabilize the current account by greater export orientation and reach a point of external balance; they must promote internal balance by reducing fiscal deficits and inflation; and they must augment productive investment so as to promote sustainable economic growth. The policies needed to achieve these objectives can be mutually reinforcing. For example, adopting credible growth-oriented policies, including realistic exchange rates, can help to restore business confidence, thereby stemming capital flight. Similarly, permitting access to private markets and lowering barriers to private capital flows into countries can reinforce efforts to stimulate growth.

Although current account approaching balance . . .

Substantial progress towards adjusting current account imbalances has already occurred, with the aggregate deficit for the Baker Plan countries having fallen from $55 billion in 1982 to an estimated $7 billion in 1988 (Figure 1). Initially, this progress arose mainly from a sharp compression of imports; however, more recently there have been gains in export volumes and for some countries improvements in the terms of trade. Export volumes have responded as exchange rates have been brought to more realistic levels and as economic policies have begun to encourage a more outward orientation of the domestic economy. Countries will need to continue these efforts in order to consolidate and build on these gains by ensuring that competitive exchange rates are maintained, and by restructuring commodity taxation, subsidies, tariffs, and quotas to encourage an increasing outward orientation of their economies.

. . . greater export orientation needed

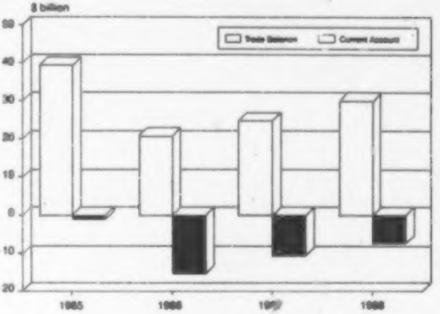
Financial sector reform can facilitate implementation of incentives for growth

As to the need to promote sustainable growth, a critical area is financial sector reform and liberalization, which can provide the basis for putting productive enterprise, both private and public, on a sound financial footing. Financial reform can mean as little as freeing deposit interest rates to encourage efficient mobilization of domestic savings or ending credit allocation to preferred sectors at preferential rates of interest. More comprehensive programs can be implemented, for example, developing non-bank intermediation channels and local equity markets or opening the financial system to unfettered international capital flows. When properly integrated with other policy changes, financial sector reform can facilitate successful implementation of debt-for-equity, privatization, fiscal reform and monetary policy reform programs.

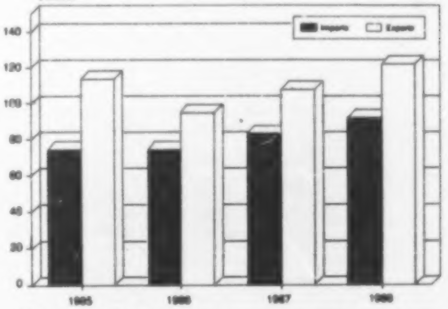
Bolder steps to open economies and expand scope of private sector are indispensable

Countries also must take bolder steps to open their economies to foreign investment and expand the scope of the private sector. Lowering tariffs and import restrictions is essential so that domestic industry has to meet the test of international markets. Necessary actions to encourage growth include increasing the scope for debt-for-equity conversions, reducing sectoral constrictions and other barriers to foreign direct investment, as well as adopting policies to bolster the private sector. Privatization will have to proceed rapidly in countries where the government sector is large, especially when it is operating at a deficit. The key to growth lies in increasing productive investment, and satisfactory investment levels often require

Figure 1
Baker Plan Countries*
Current Account Balance**



Trade Performance



* Includes Argentina, Bolivia, Brazil, Chile, Colombia, Cote d'Ivoire, Ecuador, Mexico, Morocco, Peru, the Philippines, Nigeria, Uruguay, Venezuela, and Yugoslavia.

** Excludes official transfers.

supplementary foreign capital. Moreover, direct investment facilitates the transfer of technology and financial and managerial expertise, thus contributing to the dynamic process of growth and access to export markets. While direct investment must also be serviced, payments are more flexible and reinvestment is a positive option.

Brazil, Chile, and, to a more limited extent, Mexico have been taking advantage of present conditions in international capital markets and are pointing the way for other countries to accelerate the resolution of their own debt problems. The key measure which these countries have taken is to make their economies more open to private foreign investment. At the same time, they have begun to strengthen the private sector by implementing appropriate liberalization and structural adjustment measures, including cutting back the government sector.

By easing restrictions on investment from abroad and leaving the private sector free to negotiate, it has been possible for them to restructure and recapitalize key industries. The inward flows of capital have been helped by an active market in existing bank claims, which has provided creditors with an alternative to holding their existing assets. Many of these creditors have chosen voluntarily to convert their claims at a discount, while in many instances claims have been sold to residents which have begun to repatriate capital held abroad. The result has been a significant reduction in overall levels of external indebtedness and debt service.

The process has advanced furthest in Chile, where it has been underway since 1985, and at this time the results are clearest there. However, during 1987 the process has accelerated sharply in Mexico, and significant amounts have been converted in both Mexico and Brazil in 1988. Elsewhere, it is clear that attracting private foreign investment is associated with sustained economic growth, for example, in many of the rapidly growing countries of Southeast Asia and in the capital-importing industrial countries such as Australia, Canada and the United States.

Foreign creditor confidence will respond to an opening of the economy and strengthening of the private sector

The financing for Brazil 1988 has demonstrated that new money and debt reduction can go hand in hand. This is possible when debt reduction is a voluntary option and the ability to make equity investments is attractive and relatively unconstrained. The experience of Mexico shows that a positive approach to foreign investment can speed up the process of privatizing and restructuring inefficient public enterprise. These countries together show that a dynamic private sector, open to foreign investment, builds confidence and encourages a reflow of flight capital. In contrast, the countries which have resisted opening their economies (e.g., Argentina) have been less successful in either reducing debt or attracting new money.

Improved asset and liability management provides benefits

Countries could benefit also by adopting improved asset and liability management techniques. Volatility in exchange rates and interest rates in the 1980s has led to a high degree of unpredictability of the ultimate cost of debt contracted by these countries. Through rapid product innovation and liberalization in major financial centers, high-volume markets now exist in which significant amounts of sovereign debt could be hedged. Swap operations, however, incur both a transaction cost and credit risk. In this connection, the World Bank is the natural party to play a supporting role because it is already heavily involved in the swap market. It should take the lead in a joint effort to improve the liability management of debtor countries, including selective provision of swap cofinancings and swap guarantees. Member banks are prepared to consult on appropriate measures that they can take to assist the effort in general as well as in individual countries.

Long-term interests of debtors and banks are interdependent

The long-term interests of middle-income countries and their international banks are interdependent. Because of this, banks see the continued need for both new money and voluntary debt conversion. Both are possible under conditions which meet the test of bankable business. Banks in 1985 publicly stated their endorsement of the Baker initiative and support a cooperative strategy that is growth-oriented and case-by-case. However, there have been developments which limit the extent of banks' participation in the concerted lending process. Actions are therefore needed to ensure that banks will be able to continue to play a constructive and effective role in financing growth and development.

a) Recent Trends in Bank Lending

Banks have been responsive . . .

. . . and innovative

In the space of six years since 1982, banks have agreed to postpone repayment of principal on loans totaling $395 billion, to maintain $24 billion in short-term trade and interbank lines, and to provide $50 billion in new money commitments to the Baker 15. This is strong evidence of banks' continued participation in the process. Banks have lowered fees and interest rate spreads and extended grace periods and maturity dates. Banks have been innovative in organizing credits and finding new financial techniques. Bank Advisory Committees have coordinated the lending of banks of different national groups and have arranged substantial packages of "new money" as financing needs have persisted. Banks have responded to particular problems with special solutions. These include, in 1982, basing new loan commitments on existing credit exposure; in 1983, maintenance of trade and interbank facilities; in 1984, multi-year rescheduling arrangements; in 1985, debt-for-equity swaps; and in 1987, a menu of options. Subsequently, they have expanded and made more flexible the menu of financing options, and they have begun to use more intensively those menu items which allow individual banks to adjust the overall risk profile of their portfolio. As a result, there has been a marked expansion in voluntary debt reduction and a consequential decline in external debt servicing costs.

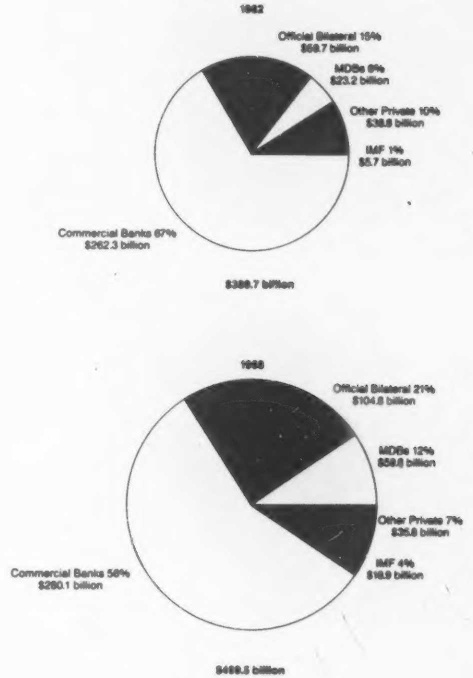
Banks' share of Baker 15 debt is falling back towards historical levels

The indebtedness of the Baker Plan countries to the commercial banks has continued to rise in dollar terms (Figure 2). But a consequence of banks continuing to make new loans, while reducing old loans, is that bank debt has risen at a slower pace in the last three years than in the preceding three years. At the same time, however, the dollar has depreciated, increasing the stock of the debt measured in dollars. The banks' share of the total external debt of the Baker countries has fallen from 67 percent in 1982 to 56 percent in 1988, and there has been a corresponding rise in the share represented by official lenders. This, however, must be seen in perspective. The strong expansion of bank lending in the wake of the two sharp oil price hikes of the 1970s marked an aberration from historical trends and it could not be expected to continue.

Baker 15 are in direct competition with other countries

There are increasing difficulties in assembling new money packages, and

Figure 2
Baker Plan Countries
Estimated Total External Debt



growing numbers of banks are withdrawing from lending to the Baker Plan countries. Banks have begun to seek more prudent and more profitable lending opportunities elsewhere. Loans to middle-income countries which have maintained creditworthiness through appropriate structural adjustment and stabilization policies have risen, just as new loans to the Baker Plan countries have declined. This serves to underscore the key point that the latter are in direct competition with the market borrowing countries for needed external finance. If they are to compete successfully with the market borrowers, they will have to adopt more effective economic policies, as detailed in Section II.

b) Factors Affecting Banks' Attitudes and Lending Practices

Failure of countries to perform consistently triggers skepticism

The most important factor has been the failure of the majority of the countries to perform consistently in the manner outlined in the Baker Plan. While there have been continuing improvements in the current account balances of these countries, the underlying domestic policies have been highly uneven. There often have been long delays in negotiating stabilization and structural adjustment programs with the IMF and the World Bank, and when programs have been agreed, governments have frequently failed to meet their commitments. This has resulted in widespread, growing skepticism among banks about debtor countries' willingness to undertake the necessary policy reforms and to persist with them.

Resort to interest arrears has chilling effect

Also, countries often have resorted to arrears rather than negotiate arrangements that would permit them to service their contractual obligations. In 1987, the Baker Plan countries accumulated an estimated $4.6 billion in interest arrears to commercial banks. Since banks have a fiduciary obligation to protect their deposits by making loans only in cases where there is a reasonable prospect of their being serviced in an orderly and timely fashion (including principal repayment), such behavior is causing lending to these countries to become even more difficult. Moreover, calls for generalized debt forgiveness are having a similarly chilling effect.

Loan loss provisions are costly to banks . . .

A related development which has affected banks' attitudes toward new lending has been the need to establish and increase loan loss provisions. Banks in most European countries steadily have set aside provisions against their loans to heavily indebted countries. By the time that Brazil declared a moratorium on interest payments in early 1987, these had reached a significant proportion of total exposure. Following the moratorium, major U.S., U.K. and Canadian banks also set aside large provisions. More recently, mandated provisions were doubled to 10 percent in Japan. The necessity to set aside provisions against problem loans is costly to banks, and has adversely affected banks' willingness to make new loans to troubled debtors. These costs are particularly onerous in situations where regulators require that additional reserves be established when concerted new loans are made, and where the tax implications of establishing loan loss provisions cannot be realized until losses are actually recognized by tax authorities.

. . . but do not free borrowers from obligation to service debt

Some observers have read bank provisioning as a signal of ability and willingness to write off sovereign debt and even to forgive it outright. This is a very serious misunderstanding. Bank provisioning is reflective of prudence and conservative accounting; it does not free borrowers from their contractual obligation to service debt or banks from their fiduciary obligation to collect it. The same is true of write-downs, write-offs and other accounting valuations at less than full face value.

Secondary market quotes are not reflective of underlying value of bank claims

A third, but again related, development has been the emergence of a growing market in existing bank claims on heavily indebted countries in the last few years. Estimates of the size of this market are unreliable, but trading volume is a small percentage of outstanding bank claims on this group of countries. Trading volume has increased as those banks with no future business plans for these countries have sold their claims for cash and as other banks have consolidated their holdings into fewer countries or changed the portfolio mix by swapping claims. Non-bank demand for these claims has been primarily associated with opportunities for debt-for-equity swaps offered by some of the countries. The thinness of the market and the fact that numerous transactions have occurred outside of the market with negotiated prices substantially above the market prices demonstrate that the indicative market quotes do not reflect the underlying value of a country's obligations. Therefore, it is an unsatisfactory basis for pricing debt reduction.

The base for new lending is eroding . . .

The development of this market has had both positive and negative effects on banks' attitudes toward additional lending. On the one hand, it has provided an opportunity for banks to rebalance their portfolios and stabilize risk profiles by exchanging claims on particular debtors and converting debt for equity. On the other hand, some banks have used the secondary market as a means of retiring from the new lending process. This, in itself, is not undesirable, particularly when existing claims are exchanged for equity which can reduce a country's overall external debt servicing cost while financing productive domestic investment. But when claims are exchanged with another creditor for cash, it erodes the base for new concerted lending, without producing a corresponding reduction in a country's debt servicing costs.

. . . and underscores need for expanding menu of options and incentives

There has been a continuing reduction in the number of banks participating in new money packages, creating pressure on banks that respond to new money requests to make up for the shortfall. There are banks that do not respond to a debtor country's request for new money but continue to receive their share of interest due on previous loans. In addition, some banks contribute less to new money packages than what other banks regard as a fair share. These developments have created tension both within and among national banking groups. They therefore place an increasingly heavy burden on banks that remain in the concerted lending process and threaten to bring it down. Moral suasion has become less and less effective in solving this problem. This highlights the need to develop, on a case-by-case basis, an expanding menu of options and incentives, including credit enhancement, that will permit individual banks to pursue alternatives that are in conformity with their own circumstances and yet continue to participate in a meaningful manner in new money packages.

Continued sovereign lending requires acceptable risks and competitive returns

Another factor affecting banks' attitudes to new lending has been the need for banks to continue to improve their capital base, on which their strength vis-a-vis other financial institutions and their ability to make new loans ultimately depend. A growing number of banks are withdrawing from sovereign lending because of perceived political and economic risks. Moreover, new G-10 bank capital requirements discriminate against sovereign lending to non-OECD countries. For banks that continue to have an international presence, the ability to allocate scarce capital in support of new lending to developing countries will be increasingly limited unless such lending provides acceptable risks and earns a competitive return. This is particularly true in Baker Plan countries where new loans and higher provisions may go hand in hand.

Finally, greater differences among banks, especially among national groups, have become apparent. The depreciation of the dollar, which has greatly reduced the exposure of banks outside the United States and Canada to the Baker Plan countries as a percentage of their capital, as well as divergent prudential, disclosure, regulatory, tax and accounting considerations contribute to these differences.

Cohesion among banks has declined . . .

As a result of these developments, cohesion within the banking community has declined. Many banks question whether their own interests are best served by continuing with a collective strategy of concerted lending. Some banks have concluded that their interests are best served by reducing their overall exposure to the Baker Plan countries. Increased provisions strengthen the financial system and reduce systemic risks, but at the same time, they imply that most banks are strong enough to refuse to participate in future lending packages, and even to run down existing exposure. In short, for many banks the benefits of maintaining the existing collective strategy have diminished, while most banks' willingness to make new loans to troubled debtors has declined. This means that they will participate in the future only if they can be convinced that their new loans will be serviced in a timely fashion and that the value of their existing claims is thereby increased.

. . . and banks need new assurances

c) Actions Needed to Sustain the Concerted Lending Process

Banks need a broader menu

It is vital that money continues to flow to those Baker Plan countries making the necessary economic adjustments. The key to success lies in recognizing that banks are not a monolithic group. They have diverse interests and have developed different strategies which can be accommodated by further expanding the menu approach. Broadening of the menu of options and incentives, including provision of credit enhancement by third parties, can also mitigate the problem of non-participating banks.

It is also important that the separate financing roles of official and private creditors be recognized. First, official lending should not be guided by the risk parameters governing bank lending, but by the long-term national interests of creditor governments in sustaining an expanding world economy. Second, bank lending to finance balance of payments deficits is not a traditional banking practice. In the 1970s, banks were encouraged to make such loans to recycle the huge OPEC surpluses, and, in the 1980s, as part of the concerted lending process, they made such loans to help finance the initial adjustments. In the future, bank lending will move increasingly from balance of payments financing back to transactional and investment finance, and general purpose financing must be provided increasingly by official creditors.

Banks require opportunities for transactional and investment finance . . .

. . . which is also in the interest of the Baker 15 . . .

Recent bank restructuring agreements have started to reflect a shift in emphasis by offering lenders a broadening range of financing options. These options include specific purpose lending which is consistent with debtor countries' needs to spur productive sector (particularly export) growth and banks' needs to finance identifiable business activities. The agreements also widen the options to convert debt to equity, again consistent with countries' needs to build equity investment and reduce debt-related outflows and with some banks' preference to invest directly or provide a channel of investment for their corporate clients. Finally, they include other types of negotiable instruments with preferential characteristics as well as options to swap existing claims for exit bonds which release banks from new money requests.

. . . and the Brazilian package was a good beginning

The 1988 agreement with Brazil offers the best example to date of the possibilities inherent in the menu approach. The financing package provides various incentives. The $5.2 billion new money portion contains new money bonds, trade financing, cofinancing and parallel financing. All of these funds are eligible for equity swaps under an auction system; in addition, the $3.3 billion parallel facility offers an asset swap at 100 percent of face value and is also available for relending to local enterprises. For banks not wishing to participate in the new money package, the Brazilian agreement provides exit bonds with a maturity of 25 years and a fixed interest rate of 6 percent. Since the bonds are exchangeable for indexed local currency bonds or for equity claims, they will not only lower the future interest requirements on Brazil's external debt, but may also result in a reduction of that debt. Over 100 banks have converted existing loans into Brazilian exit bonds and of these about 50 have converted their entire medium- and long-term Brazilian portfolio.

Creditor countries must demonstrate confidence in Baker 15 policies

Going forward, an essential requirement is for better economic performance by debtor countries. Debtor governments must commit themselves to far more comprehensive structural reform and liberalization than seen to date if they want private lenders to commit additional resources. To secure such commitments, creditor governments will have to support debtor governments willing to undertake suitable reforms, both directly and through the international financial institutions.

But the concerted lending process also needs reinforcement from the per-

Because debtors require a predictable source of financing…

spective of debtor countries, particularly if they are to implement the kinds of policy changes and make (and keep!) the kinds of commitments which are needed. The most important support which a debtor can receive is a commitment to provide a source of financing that can be counted on in the medium term. Multi-year commitments of financing can underwrite the medium-term structural adjustment programs that are needed to ensure a durable return to higher economic growth. Such logic underlies the recent decision by the IMF to make commitments of up to four years under the revitalized External Financing Facility and to create a new Contingency Financing Facility.

…banks will do their part…

Banks also recognize the constructive contribution that a multi-year commitment can make. Thus, as part of the strategy of redirecting their lending and fostering structural reforms and liberalization, banks will consider multi-year financing commitments, in the context of an expanded menu approach, to support economic growth when there are productive investments to be financed. To be consistent with bankers' fiduciary responsibilities, such commitments would have to be linked to similar multi-year commitments and adequate flows of funds from the IMF and the World Bank. They would also be conditional on debtor governments continuing to implement development strategies that give priority to the private sector. The latter is crucial because promoting the private sector will provide needed opportunities for banks to engage in project lending, onlending, and trade finance as well as domestic banking.

…if others do theirs

There are a number of positive actions which governments in the debtor and creditor countries need to take in order to make concerted lending more acceptable to banks. Creditor governments can provide support in the form of direct financial assistance to these countries and in the form of direct comfort to banks on their new loans, for example, by providing better cofinancing opportunities with the multilateral institutions or guarantees as to interest and/or principal. At the same time, debtor countries will want to take advantage of new market techniques which can bring about reduced external debt service costs and thus the need for new money. These market techniques can also benefit from third party enhancement. Voluntary debt reduction can be accommodated within the concerted lending strategy, and, by accommodating both banks that have no continuing business interests in the country as well as banks that wish to change the nature of their ongoing business claims, may in fact strengthen the debt management process.

Debt forgiveness is a defeatist strategy

The slow progress made in solving the problems of some Baker Plan countries has been accompanied by growing creditor and debtor fatigue and has contributed to the politicization of the debt problem. From time to time, this has resulted in calls for generalized solutions, including mandatory debt forgiveness. Generalized and mandatory debt forgiveness is a defeatist strategy. It will disrupt the concerted lending process and delay indefinitely countries' vital access to financial markets and private investment from abroad.

When market sentiment is unfavorable and banks are having difficulties in sustaining lending, it is disruptive and unwise to make matters worse by proposing that banks forgive debt. Nevertheless, over the last year, there has been renewed attention focused on generalized debt relief schemes and debt forgiveness for Baker Plan countries. These would require only banks, and not other creditors, to cancel an arbitrary portion of their claims on indebted countries or sell them to an international agency at a steep loss. This amounts to mandatory debt cancellation, differing sharply from market-oriented voluntary exchanges discussed in the next section.

Countries would pay a stiff price because…

If creditors' property rights are violated by the implementation of confiscatory schemes, private lenders will rightly fear that debt forgiveness is institutionalized and a permanent feature of the system. The lessons of history, no less the recent experience in Peru or Brazil's payments moratorium during 1987, teach that countries pay a stiff price in terms of loss of access to international capital markets, including crucial trade and interbank lines. Generalized debt forgiveness would be especially detrimental to those countries approaching reaccess to markets and could even damage those currently enjoying limited market access.

…future private capital flows are threatened

Banks do not believe that mandatory debt forgiveness would be in the interests of the Baker Plan countries. It would be self-defeating since it would choke off the future capital flows from private sources which are absolutely crucial to growth and development in the middle-income countries. There is a moral hazard because bad performance would be rewarded. Mandatory debt forgiveness deals with the symptoms, not the causes. It might well result in a relaxation of financial discipline, which could only delay the needed policy changes. And without changes in policy, debtor countries soon will be unable to service any future obligations that they might hope to attract. Thus, no lasting solution can be achieved through debt forgiveness; indeed, debt forgiveness seems likely to ensure that middle-income countries will become the wards of taxpayers in the industrial countries, dependent upon them for foreign aid and competing with the poorest countries for the meager amounts of aid that are available.

Mandatory forgiveness is inequitable and politically impractical…

Mandatory debt forgiveness would be inequitable, both to those indebted countries that have made sacrifices to maintain their creditworthiness as well as to private debtors in the industrial countries which have experienced hardship. It would be grossly unfair and politically untenable to forgive the debts of middle-income countries, whose external and internal assets are considerable, without granting similar treatment to distressed farmers or households residing in the jurisdictions in which banks operate.

. . . and raises serious legal complications

Obviously, serious legal complications would result from any mandatory debt relief. In the United States outright mandatory debt cancellation would be an unconstitutional taking of property unless prompt, adequate and effective consideration were afforded. Schemes designed to conceal a taking over of property in an effort to avoid the constitutional confrontation would be contested in the courts. If such a contest revealed a taking without consideration, the scheme would be held to be unconstitutional. While not all jurisdictions provide a constitutional protection, or the same requirements of prompt, adequate and effective compensation, a taking of property without compensation is considered equally abhorrent and deserving of compensation. This being understood, any such taking requires that governments provide compensation.

Debt forgiveness is equivalent to foreign aid . . .

Debt forgiveness also raises questions about the proper role of governments. At the 1988 Toronto Summit meeting, governments agreed on a framework to extend debt relief to the poorest countries. As one option, some governments have forgiven a portion of the debt of the poorest of the low-income countries in sub-Saharan Africa. Because these countries are overwhelmingly dependent on financing from official sources, forgiveness is a form of foreign aid. Forgiveness may be appropriate in these circumstances since foreign aid is a legitimate function of governments. But commercial banks cannot be in the business of providing foreign aid.

. . . but banks are not in the foreign aid business

In a recent communiqué, G-7 governments encouraged the development of "market-based and voluntarily agreed financing options under the menu approach in order to facilitate new financial flows." In the words of U.S. Treasury Secretary Brady, such options must "maintain the willingness of private lenders to continue financing future development." Mandatory debt forgiveness would destroy such willingness.

In coming months, governments of the industrial countries will have to address their own role in restoring growth and strengthening the external accounts of the Baker Plan countries. Banks' views on the role of creditor countries are set forth below; they certainly exclude official support for mandatory debt forgiveness schemes.

Voluntary debt reduction works

The last two years have seen expanding use of innovative, voluntary and market-based financial techniques which reduce the outstanding external bank debts and debt service obligations of Baker Plan countries. Such techniques can be applied to both private sector and public sector debt. They include debt-for-equity conversions, debt-for-debt conversions, and debt-for-debt conversions which permit substitution of local currency obligations for foreign currency debt. These techniques reduce external indebtedness because existing debts are exchanged at a discount for new claims. Others rely on exchanges which leave the face value of debt outstanding unchanged but reduce the annual debt service cost. The exit bond as a supplement to new money packages has been used in this fashion.

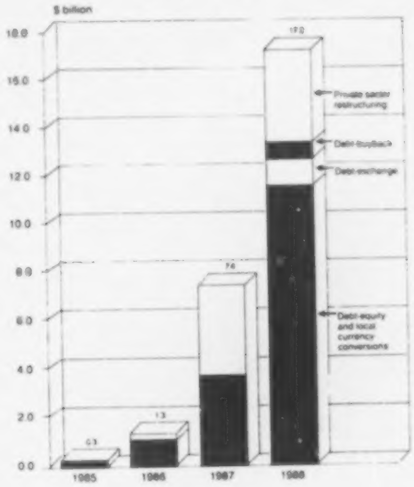
From the perspective of both creditor and debtor, the objective is to exchange an existing claim for another claim with different characteristics. In the case of a debt-for-equity conversion, for example, an obligation to pay interest in foreign currency and to repay principal on a certain date is exchanged for an ownership claim which yields a variable rate of return, typically in local currency and subject to local taxation, and without a specific time to repay. In the case of the exit bonds that have been issued so far, the creditor exchanges his claim to an interest payment stream at floating rates for a fixed payment stream at a lower rate of interest but under the arrangements governing new money packages is no longer obliged to provide credits in the future.

The most important aspect of these exchanges is that they are market-driven and therefore voluntary. Because they are voluntary, they are motivated by the self-interest of the respective parties. A primary objective of the debtor is the achievement of reduced external debt service costs. Such funds then can be channeled into productive domestic investments to facilitate structural reform. Associated benefits include recapitalization of the private sector, financing of privatization and repatriation of flight capital. The objective of the creditor is to exchange his existing claim for cash or a new claim which is of greater intrinsic value to him. Although the payment stream initially may be lower, there will be other enhancements. For example, the obligation may be guaranteed, the payment stream may be more certain, or it may hold out the prospect of a greater yield at some later date.

$26 billion in bank debt converted to date

Voluntary reduction of bank debt takes place through a wide variety of financial transactions. Some of these transactions are conducted through formal channels established and managed by the national authorities; however, a large share takes place on an informal basis in the private markets. Because of their diverse nature, information on these transactions is incomplete, and it is often difficult to identify their impact on a country's balance of payments and external asset position. Figure 3 shows the Institute's estimates of the face amount of voluntary reduction of debt owed to foreign banks. The total amount already exceeds $26 billion and approaches almost 10 percent of the bank debt at end-1984. These estimates include the conversion of external debt to equity and local currency financial assets.

Figure 3
Baker Plan Countries
Estimated Face Amount of
Voluntary Bank Debt Reduction



the debt buybacks by Bolivia and Chile, the exchange of debt for bonds by Mexico, and the restructuring and settlement of debt owed by the private sector (e.g., the IFC-supported debt restructuring of the Visa Group in Mexico). The estimates exclude the purchases of sovereign debt by residents and financial institutions of the debtor countries that are not covered by formal programs since statistics for such purchases are not made available.

Chilean bank debt is down by 36 percent

The main vehicles have been debt-for-equity and local currency conversions and private sector restructuring. The reduction in bank debt has been significant for several countries (Figure 4). In Chile, for example, cumulative debt reduction amounts to over 36 percent of the bank debt outstanding at the end of 1984. This should spur other countries to implement similar programs. A breakdown of bank participation, were it available, would show that many banks have either reduced their exposure to these countries or obtained an equity investment.

There are net benefits for debtor countries . . .

For a sovereign debtor, the potential benefit for reducing its external debt servicing costs depends on the discount at which existing debt is exchanged, and the gain from this exchange must exceed the costs. In the case of debt-for-equity swaps, for example, these costs can appear as a need to modify attitudes towards foreign ownership, to raise appropriate local currency funding, and to fit such funding into credit control programs in order to avoid adverse inflationary consequences. The potential benefits from debt-for-equity swaps will, however, not be realized if countries run their programs on a stop-and-go basis.

. . . and creditors as a group

Creditors as a group, both official and private, benefit from voluntary debt reduction because it increases the probability that remaining debt will be fully serviced. For the individual creditor, the cost is the discount incurred in exchanging old assets for new assets, but the benefits accrue to all creditors and to the debtor country because its external debt servicing costs are reduced. Thus, particular creditors benefit if other creditors can be induced to reduce their claims.

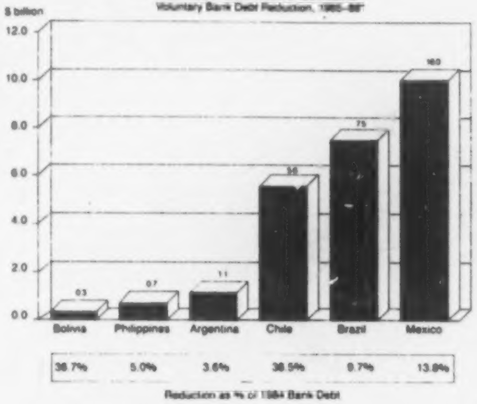
For individual banks, the net benefit depends on their own circumstances

The gains from voluntary debt reduction for individual banks depend on their particular circumstances. Some banks anticipate that by reducing their exposure to troubled debtors they stabilize their risk profile and that the market price of their shareholders' equity will rise. Others may anticipate that their abilities to comply with newly regulated capital requirements, or to implement particular competitive strategies, are improved. Often the benefits will depend on the enhancements or different characteristics associated with the new asset received in exchange for the existing claim. In the case of the Mexican debt exchange, for example, marketable bonds which yielded a higher rate of interest and collateralized principal at maturity with U.S. Treasury bonds were provided in exchange for old loans at a discount. Banks will value the enhancements according to their particular circumstances, which will be determined in part by their national tax and regulatory requirements as well as by portfolio considerations, and will voluntarily switch assets when they can gain from doing so.

Figure 4

Selected Baker Plan Countries

Estimated Face Amount of Cumulative Voluntary Bank Debt Reduction, 1985–88[*]



[*] Includes conversions of bank debt to equity and local currency financial assets, debt buybacks, debt exchanges, and restructuring and settlement of debt owed by the private sector.

The Mexican debt exchange illustrated some important principles regarding voluntary debt reduction. The first is that there are limits to the amount of debt that can be converted at prices close to those prevailing in existing secondary markets. Since most banks perceived only limited opportunities to improve their position, they chose not to participate in the exchange. The second is that it is a relatively straightforward exercise to expand the scope for voluntary debt reduction. Simply put, the amount of debt converted can be increased by enhancing the quality of the new asset. In principle, quality enhancements may be in more conventional forms such as collateral or a guarantee, or in less conventional forms, such as commodity linkages.

Enhancements are crucial to the expanded use of voluntary debt reduction

Some indebted countries may be in a position to provide enhancements out of their own resources and thus benefit from voluntary debt reduction. The examples are likely to be limited, however, since providing financial inducements reduces the net financial benefits of the transaction, and few debtors have resources adequate to provide a meaningful amount. In these circumstances, there is a case for creditor governments and the international financial institutions to provide assistance possibly through guarantees of principal or interest. Since international financial institutions as a matter of policy do not reduce their claims, providing enhancements to conversions by banks would recognize the improvement in their own assets. Another potential form of assistance would be for creditor countries to adjust and harmonize the tax and regulatory environment in order to encourage banks to engage in voluntary debt exchanges.

Creditor governments can assist . . .

Banks, too, in some circumstances may be able to assist countries to encourage larger amounts of voluntary debt reduction. The direct government buyback by Chile in November 1988 featured the government using windfall gains from higher than expected copper prices to purchase debt directly from banks at prices near secondary market levels. On the creditor side, sales for cash were obviously acceptable, but the amounts involved were small. Of potential significance, the direct buyback was done under a waiver from creditor banks. Although banks generally take a cautious approach to providing waivers, Chile's creditors judged that the direct buyback did not imperil debt servicing on other debt and that repayment of some bank creditors benefited the remainder.

. . . as can banks

Even more important than financial and regulatory enhancements or waivers are policy actions by debtor countries. The way forward has been shown by Brazil, Chile, and Mexico, which through structural adjustment and deregulation have begun to ease the restraints on private sector initiative in their own countries and to open their economies to direct investment. This has expanded the scope for voluntary debt reduction through debt-for-equity and local currency conversion. Banks as well as residents with capital abroad and other potential investors have responded quickly to these enlightened acts of self-help.

. . . but debtor governments must open their economies to more direct investment

Despite the advantages, there are obstacles to expanding foreign access to the local economy, and they have to be overcome. To promote foreign investments, governments need to cope with elements of nationalism and with protectionist interests that are deeply entrenched and often powerful. But such steps encourage the expansion of productive investment that is the precondition for sustained economic growth and strengthening the external accounts.

Creditor governments are responsible for the general environment

Governments of the creditor countries share the responsibility for the resolution of the problems of the Baker Plan countries. Their fiscal and monetary policies largely determine world interest rates and the exchange rates of the key currencies. Their trade policies have a direct impact on the chances of these countries to export more. Their policies set the stance for the export credit agencies, the Paris Club and the international financial institutions. Their regulatory and tax policies have a major effect on the flow of financial resources throughout the world.

Their macroeconomic performance has been mixed

The performance of creditor countries has been mixed. While growth of output and trade has been reasonably well sustained, real interest rates have remained high and financial markets have been volatile. Since 1985, cooperation among the major economic powers has improved, but current account imbalances among the three largest industrial countries are still unsustainably large, and only slow progress is being made in correcting them. Inflation has begun to accelerate again in some leading industrial countries, posing the threat of corrective monetary adjustments and even higher interest rates.

The shortage of world savings . . .

Budget deficits continue to absorb an inordinate amount of private savings in many industrial countries and the historically high level of real interest rates indicates a shortage of world savings. Since most of these savings are generated in the industrial countries, they hold the key to increasing net capital flows to the developing countries as a group. On current estimates, however, the industrial countries will run a current account deficit of some $50 billion in 1988. Even if the industrial countries are net capital importers, there is, of course, always scope for intermediation through the banking system so that savings can flow to a particular developing country. Clearly, the Baker Plan countries are presently unable to compete for substantial amounts with other borrowers in the global capital market.

. . . means Baker 15 must compete for limited funds

Growing protectionism threatens progress

On the trade front, industrial countries have not lived up to their promises. Legislators in industrial countries have added to the protectionist arsenal, not subtracted from it. As a result, the Baker Plan countries have not been able to exploit fully their comparative advantage and enhance their debt servicing capability. Agricultural protectionism remains a matter of particular concern, but the concern extends as well to steel, textiles, garments, footwear and many other products these countries are able and eager to export. Industrial countries need to open their markets if indebted countries are to grow and strengthen their external accounts.

Export credit agencies must lead, not lag, private sector

Creditor country governments need to foster specific policies that have an immediate bearing on the debt problem. The cover policies of many export credit agencies are a case in point. Since these agencies were created to assume levels of risk that individual traders and bankers could not absorb, they must take the lead, not lag behind the private sector. The policy of the Export-Import Bank of Japan of making untied loans in connection with IMF and World Bank programs represents a very positive step undertaken by a major creditor government. Other surplus countries should follow suit. The lending and rescheduling policies of the creditor governments have been slow to adjust to the changing needs of the Baker Plan countries. For many of these countries, access to long-term export credits has been limited by restrictive cover policies of the official agencies. Moreover, Paris Club rescheduling agreements with these countries have not been done within a multi-year framework or included innovative financing arrangements to reduce debt and future debt service payments. These agreements carry market interest rates on rescheduled debt and establish cutoff dates after which new credits are excluded from future restructuring.

Regulatory and tax policies must be accommodative

Banks continue to be concerned about the impact of creditor countries' regulatory, accounting and tax policies on their ability to make new loans and to restructure existing debt. Mandatory reserving against bank claims on troubled debtor countries, which has been institutionalized and broadened in important creditor countries, hampers new bank lending and sometimes fails to recognize improvements in the creditworthiness of debtor countries. Limited or uncertain tax deductibility of reserves, especially if these reserves are mandatory, has an adverse effect on banks' willingness to engage in new transactions. Moreover, a broader menu of options requires a regulatory, accounting and tax framework that is conducive to innovation; this is particularly true for debt reduction programs.

All the points made above concern the general environment for the Baker Plan countries. Even with modification in present policies and successful coordination of macropolicies among the G-7, questions persist as to whether more is needed.

The Japanese government is apparently willing to support certain types of voluntary debt conversions as part of the menu of options. A ''Marshall Plan'' for the Philippines with official bilateral financing coordinated by the World Bank is also being considered. Such coordinated action among creditor country governments should be extended to other debtor countries.

Recent attempts in Mexico to restore price stability have been expensive in terms of low growth and loss of exchange reserves. The United States has recognized this by providing a temporary bridge facility of up to $3.5 billion. The potential benefits from stopping inflation are so great, however, that converting the facility into a longer-term stabilization loan may be warranted. U.S. support was a key element in the success of a similar stabilization program in Israel.

Governments should provide credit enhancement

Creditor governments also should seek other ways in which they (or the international financial institutions) could encourage banks to make new loans within the context of concerted lending and accelerate the application of voluntary, market-oriented financing techniques that reduce existing bank debt. Providing guarantees as to interest and/or principal would be one way of doing so, both with regard to new loans and debt conversions. The importance of credit enhancement from the official side is that it is a part of the new rationale needed for banks to stay in the process and the ingredient needed to lay the basis for long-term bankable business. It therefore can insure that the collective benefits of concerted lending

are fully realized. To the extent that creditor governments (or the international financial institutions) provide such credit enhancement, it should be structured and utilized on a case-by-case basis in the manner which will best facilitate a particular debtor country's regaining access to the global capital market.

Broad political implications call for stepped-up role for creditor governments

Creditor country governments can and should accelerate the restoration of growth in the Baker Plan countries, both through better macropolicies and more forthcoming micropolicies. Such policies are in the economic self-interest of the industrial countries but, more importantly, they also serve their geopolitical interests. It is these broader political implications that call for a stepped-up role of the creditor governments vis-a-vis the Baker Plan countries.

Financial commitment of international financial institutions must be expanded

Banks continue to believe that a strong and expanded role for the International Monetary Fund and the World Bank in supporting and monitoring policies for economic growth and adjustment in the Baker Plan countries is essential. Firm conditionality must be an integral part of IMF and World Bank assistance.

IMF

IMF now a net taker of funds

In the early days of the management of the debt problem, the IMF was a major provider of funds. Total non-concessional IMF claims increased from SDR 19.3 billion at the end of 1982 to SDR 35.2 billion at the end of 1985. Since then, they have declined to SDR 26.5 billion at the end of October 1988. The IMF should recognize that balance of payments deficits needing temporary financing are widespread and should be seeking to lend to countries which can meet the conditions of IMF support. Such support should be provided until the country reaches an advanced state of adjustment and approaches market access once again.

There is also a need for more extended commitments by the IMF, both in terms of the period for which an IMF program is agreed as well as for the average and final maturities of the loans made by the IMF. Banks welcome the recent agreements reached by the shareholders of the IMF to improve the Extended Fund Facility.

Contingency Financing Facility can be strengthened

The IMF has also responded to the challenge adverse external events can pose to the adjustment efforts of debtor countries by creating a new Contingency Financing Facility. This addition is welcome. As presently structured, the facility will not, however, provide sufficient resources to make a meaningful dent in the increased debt service cost that has already occurred as a result of recent interest rate hikes. There is a way in which the facility can be strengthened without increasing the claims on the resources of the IMF and the liabilities of the debtor countries. The key element would be to take advantage of the array of hedging techniques available in the marketplace, for example, to purchase interest caps to insure against interest rate risk.

Medium-term support can be expanded

While the IMF's current level of liquidity is more than adequate to support an immediate expansion of lending, an early increase in members' quotas and an increase in members' access limits would provide for medium-term support. Expanded and more predictable lending, subject to effective conditionality, would encourage debtor governments to adopt better macroeconomic policies and structural reforms and would provide linkage for future participation by commercial banks.

An SDR allocation is warranted

To strengthen the environment in which debt management operates, the Institute put forward last March a proposal supporting an allocation of Special Drawing Rights (SDRs). Such an allocation would bolster the financial arrangements to maintain orderly exchange markets and ease the financing problems of both surplus and deficit countries. The Institute believes that the arguments it has advanced in favor of an SDR allocation remain valid.

World Bank

World Bank must play an enlarged role

Banks are also strongly supportive of an enlarged role of the World Bank to promote growth and adjustment in the Baker Plan countries. They would welcome additional efforts by the World Bank to help these countries undertake structural reforms, especially those strengthening the private sector, to increase its own lending to these countries and to mobilize larger official and private flows. Banks hope that the agreed general capital increase will be speedily subscribed.

Self-imposed limits must be overcome

In financial terms, the World Bank's net contribution has fallen short of the objectives of its management and the expectations of its major shareholders and the commercial banks. Several factors have contributed to this outcome, not all of which (e.g., exchange rate movements) are under the control of the World Bank. However, self-imposed limits may have been more important. The World Bank was created as a lender of last resort to its members. Under the present circumstances, this means that the World Bank should increase its own disbursements. As explained in the preceding section, it could also provide, on a selective basis, enhancements for voluntary debt reduction programs. Banks continue to stand ready to explore non-traditional forms of financing with the World Bank.

Credit standing is not in doubt

In the present environment, the World Bank cannot be effective if it sticks to the narrow textbook definition of a catalyst, "a substance, usually present in small amounts relative to the reactants, that modifies and especially increases the rate of a chemical reaction without being consumed in the process." The World Bank can increase its financial commitments substantially without impairing its credit standing which, in the final analysis, depends on the backing of its members. Securing bilateral funding or loan purchase agreements with surplus countries would permit the World Bank to play a greater role without increasing its reliance on the global capital market.

Banks need better cofinancing opportunities

In January 1983, the World Bank, recognizing the advantages of closer interaction between official and private creditors, introduced a novel cofinancing program which included direct World Bank participation in the late maturities of commercial bank loans, guarantees of the late maturities of commercial bank loans, or contingency financing in case of an interest rate surge. The World Bank has not used these instruments vigorously. Indeed, these instruments have played virtually no role in mobilizing commercial bank lending to Baker Plan countries. This reluctance of the World Bank has added to the uncertainty existing in banking circles about the viability of the current debt strategy. Commercial lenders cannot be expected to have more faith in that strategy than the international organizations express by their restrictive cofinancing policies.

Within the limits of prudent financial management, there is room for more flexibility than the World Bank has shown in recent years. If new bank lending is to come forth in adequate amounts, ways must be found to provide measurable credit enhancement in critical cases.

Similar arguments apply to voluntary debt conversions. They are a potentially strong mechanism to reduce external debt outstanding, but they will not achieve their full potential without persistent implementation of adjustment programs and unless enhancements are provided. Proposals recently put forward by France and Japan appear to accept this argument.

IFC

Given the need to strengthen productive investment — and for almost all practical purposes this means private investment — banks look forward to an expanded role of the International Finance Corporation (IFC). Banks share the Corporation's view that more equity investment and a better financial infrastructure are needed. There are many ways the IFC and commercial banks can cooperate. Restructuring of private companies is one example. Privatization of parastatals is another. Debt-for-equity swaps in connection with IFC-sponsored projects could become a standard option in bank restructuring packages. Since banks generally prefer private sector to public sector investments, the IFC and the commercial banks are natural partners.

IFC and banks are natural partners

MIGA

Banks welcome that a new instrumentality of the World Bank Group, the Multilateral Investment Guarantee Agency (MIGA), has become operative in 1988 and hope that major Baker Plan countries will soon join. From their vantage point, MIGA makes important additions to existing bilateral programs. Banks believe that excellent opportunities exist for commercial banks to interact with MIGA and are eager to explore with the Agency possibilities for guaranteeing investment-related bank loans. At present, MIGA's coverage capacity is limited to little more than $1 billion; this capacity could be leveraged by concluding co- and re-insurance agreements with national agencies and private insurers.

Major Baker Plan countries need to join MIGA

IDB

The Inter-American Development Bank (IDB) certainly has not met the targets which the Baker Plan postulated. This is due to the debate among its shareholders about its lending policies and financing. Banks hope that these differences can be resolved and that negotiations to secure a capital replenishment for the IDB can be brought to an early and successful conclusion. Since the debt problem of the middle-income countries is concentrated in Latin America, commercial banks believe the IDB should play a major role in its resolution.

IDB must again become meaningful source of financing

Chile's Economic Revival[1]

by

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and

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(1) A paper presented at a conference on "The Unknown Revolution: Chile's Transition to Democracy," Washington, D.C., September 16, 1988.

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Recently, two Chilean "stories" have generated a considerable amount of international media attention. The first concerns the impending plebiscite in which voters will cast a "yes" or "no" vote for the Junta de Gobierno's candidate for President, General Augusto Pinochet.[1] The second story concerns the impressive economic results that have been generated by the application of economic liberalization and stabilization policies; policies that are in sharp contrast to those adopted in most other Latin American countries. These stories are, of course, related and have their roots in Chile's recent history.

The Political and Economic Crises of 1973

The year 1973 marked a turning point in Chile's political and economic history. In September of 1973, the Junta de Gobierno took over the government from President Salvador Allende. President Allende was a socialist who had been elected by the Congress after receiving a plurality of a bit more than one-third of the popular vote. The coalition of parties that eventually supported President Allende were mostly Marxists and attempted, from a minority position, to implement a variety of oppressive, interventionist measures. Eventually, the contraloria[2] declared that some of these measures were unconstitutional, and the Congress "invited" the Armed Forces to perform its constitutional duty: the removal of President Allende. With the general chaos and extreme economic crisis that existed at that time, the citizenry lent its support

to the military's action.

The Junta de Gobierno assumed power immediately after the Military Pronouncement of September 11, 1973. Members of the Junta thought that the political and economic crises of 1973 were the result of faulty economic and political institutions. Hence, they set about to implement a deep transformation of these institutional arrangements, so that prosperity, unity and internal peace could be restored. This was done "with goals, but without deadlines."

Economic Restructuring

The "Chicago Boys" -- To design and implement a new set of economic policies, the Government has relied on a group of relatively young economists. They have come to be known as the "Chicago Boys" because many were trained at the University of Chicago. The Chicago Boys have their intellectual roots in the classical liberal tradition. In consequence, they have recommended economic policies that remove government intervention in markets, strengthen the institution of private property and promote its diffusion, eliminate monopoly power in the markets for labor, goods and services, promote free trade, stimulate growth through private enterpreneurship, foster the nondiscriminatory equality of opportunity and stabilize the general price level through strict fiscal and monetary discipline.

Price Controls for Goods and Services -- The Allende government had engaged in price controls for most "essential" goods and services. With prices set at artifically low levels, production was discouraged -- particularly in the agricultural sector -- and the nation's growth rate was retarded. Moreover, the fixing of prices for public services contributed to Chile's enormous budget deficits (see Chart 1). The Junta's policy of lifting price controls has eliminated these distortions and commands widespread public support.

International Free Trade -- During the 30 years prior to the Junta, Chile had pursued an import-substitution policy. It was accomplished, in large part, by setting tariffs at an average rate of 100% and imposing a wide variety of non-tariff barriers. This inward-looking policy closed the economy from the rest of the world. In consequence, it had significant negative effects on Chile's economic performance: reduced competition, reduced domestic savings, increased the substitution of capital for labor (reduced the demand for labor) and in general slowed economic growth (see Chart 1).

During the 1974-1979 period, the Junta eliminated all non-tariff barriers and reduced tariffs to a flat 10% for all products. As a result of the 1982-83 economic crisis, the government increased tariffs to 15% for all products. However, it is anticipated that these will be reduced in the near future.

Export Growth--Chile's outward-looking economic liberalization policies transformed it from an interventionist economy that had become isolated from the rest of the world, into a liberalized,

world-integrated economy where market forces guide most resource allocation. The Chileans responded to these forces by, among other things, rapidly expanding their exports (see Chart 1). Exports now account for 31% of GNP. This is almost three times the level realized during the last decade that the import-substitution model was in place. In consequence, trade surpluses (which is estimated to be about $1.6 billion in 1988) are generated and employment opportunities realized.

Liberalization of Capital Markets -- Until 1973, the domestic capital market in Chile had been highly repressed: most banks were government-owned; negative real interest rates were typical; and quantitative restrictions on credit were pervasive. In 1974, banks were privatized. By late 1975, interest rates were completely decontrolled and non-market credit rationing was abolished. International long-term capital flows were liberated in 1980. Moreover, foreign financial institutions were allowed to establish operations in Chile; legal reserve requirements were sharply reduced; and legislation was modified to allow the financial sector to be transformed into a modern multi-banking system.

The economic crisis of 1982-1983 (see Chart 1) greatly affected the financial sector of the economy. In the years immediately prior to the crisis, foreign indebtedness had grown rapidly. For example, in 1981 it increased by almost 40% and reached 50% of GDP. Since most of this debt was private and without government guarantees, it was not viewed as an economic policy problem. After all, if a private borrower could not repay its foreign obligations, it was a private problem that would be settled in a standard bankruptcy procedure. However, as it happened, the course was not quite so straight. By mid-1981--as a result of the real appreciation of the peso, a sharp deterioration in Chile's terms of trade, high real interest rates and a slumping international economy--a number of firms in the tradable-goods sector were in serious financial trouble. In consequence, most borrowed heavily from the capital market. However, many of the loans made at that time were not entered into on an arm's length basis because local banks had equity interests in firms that were receiving loans. In consequence, many of the loans simply turned out to be bad. All this led to a serious financial crisis because borrowers could not repay local banks, and the domestic banks could not, therefore, repay their loans to international banks. In the end, the government was forced to intervene massively to salvage the nation's financial system: it liquidated four banks and intervened in the reorganization of four others. Also, even though there had been no explicit or implicit guarantees of the loans in question, the government injected over three billion dollars in loans into the system.

As a result of these events, the government had to temporarily backtrack on its liberalization policies in the financial sector. For example, in 1983 it controlled about 70% of the domestic banking industry. Since then, the banking legislation has been

reformed, bank supervision has been improved, and most financial institutions have been returned to the private sector.

Labor Markets -- Until rather recently, unemployment has been a persistent problem in Chile (see Chart 1). One contributor to unemployment was the minimum wage. For example, between 1975 and 1979, it increased by over 20% in real terms. Another contributor was the backward indexation of wages. With this indexation, nominal wages were automatically adjusted by the inflation rate in the previous months. In consequence, real wages soared, particularly in 1980-1982, because the inflation rate was falling. After the crisis, indexation was dropped.[3]

There have been other important reforms in the labor field. Collective bargaining is now at the enterprise level, rather than at a national level. Strikes are permitted under the new labor law, but so are "lock-outs."

As a result of the labor market reforms, there is a great deal more wage flexibility than there was. Hence, now wages tend to more accurately reflect the real economics in the labor market. For example, from 1981-1985 unemployment was rather high. As we would expect, real wages fell by about 15% during that period, and unemployment rates came down (see Chart 1). During the 12 months ending July 1988, however, labor markets have tightened up and real wages have increased by 8%.

Social Security Privatization -- In 1981, the social security system was radically reformed. Although the system remains compulsory, the privileges that were available to some groups, most notably politicians and public employees, have been eliminated. More importantly, the system has been changed from a public pay-as-you-go system to a private pension system in which participants have individual accounts that are managed by private pension companies. Competition among companies guarantees good service, low administrative costs and high rates of return (returns are indirectly controlled because limits are placed on the types of "secure" investments that private pension funds can invest in). Today, about 75% of the total labor force has switched from the old public to the new private system, which has already accumulated about three billion dollars in assets or 15% of GNP.

In addition to being beneficial in its own right, the privatization of social security has provided domestic capital for the Santiago stock exchange. Although limited in the amount and types of equities that they can invest in, private pension companies have invested in some of the newly privatized enterprises. This has acted to facilitate privatization.[4]

Fiscal Reordering -- To permit a rapid expansion of the private sector in a climate of stable prices, fiscal discipline has been applied. For example, public expenditures have fallen from 43.5% of GNP in 1972 to 24.3% in 1988. By engaging in an aggressive privatization program, the government has been able to focus most of its attention on social expenditures that are justified on a needs basis and/or are rationalized because they

promote equality in opportunity. At present, these so-called social expenses account for 60% of the total government expenses.

With the reduction in the proportion of the GNP accounted for by public expenditures, the fiscal deficit was reduced from 13% of GNP in 1973, the last year of the Allende government, to about 3% of GNP during the 1982-1983 economic crisis, and presently to a projected surplus. The spending restraint has also allowed for growth-oriented tax reform and rate reductions. The most recent reduction was a 20% reduction in the value-added tax, which is the government's most important revenue source.

Chile's Savings Rate -- Until rather recently, the domestic savings rate has been rather anemic. This was due, in part, to the large increase in Chilean asset prices prior to the 1982-1983 crisis. Savings decisions are dependent on the differential between actual and desired wealth. In consequence of the dramatic increase in asset prices (wealth), Chileans were not motivated to save at high rates. Since the crisis, however, the savings rate has increased smartly, and is now running at about 24% of GNP.

Concluding Observations

Today, Chile is finally benefiting from a long structural adjustment (see Chart 1). There are no visible economic imbalances; economic growth is strong; real wages are moving up; profits are signficiant and growing; unemployment is coming down; the inflation rate is falling; the external trade and fiscal accounts are in surplus; and the private sector is growing relative to the public sector. In short, Chile's economic liberalization and stabilization policies are on course and bearing fruit. There is only one outstanding set of questions (risks): What about the political situation?[5]

Footnotes

[1] For an analysis of the plebiscite, see: Rolf J. Luders and Steve H. Hanke, "How the Media Slight Pinochet," *The New York Times*, July 15, 1988.

[2] The *contraloria* is a government agency -- independent from the executive, legislative and judicial branches of government -- that certifies *ex-ante* the legality of all government actions.

[3] We should mention the policies of wage indexation and fixed exchange rates amounted to the imposition of two *numeraires* in the economy. In consequence, relative prices could not adjust to the crisis of 1982-1983. This put the adjustment burden solely on the back of "quantities." Not surprisingly, production and employment fell rapidly during the crisis (see Chart 1). For a discussion of these issues, see: Rolf Luders and Steve Hanke, "Bringing Chile's Economy Back," *The Washington Times*, August 1, 1988.

[4] Chile's unique debt-for-equity swaps have also injected capital into the equity market, which has facilitated privatization and reduced Chile's external debt. For a discussion, see: Steve H. Hanke, "The Anatomy of a Successful Debt Swap," in: Steve H. Hanke (editor), *Privatization and Development*, San Francisco: Institute for Contemporary Studies Press, 1987.

[5] For an answer, see: Rolf J. Luders and Steve H. Hanke, "How the Media Slight Pinochet," *The New York Times*, July 15, 1988.

Chart 1. Chile's Basic Economic Statistics

(Selected Years)

	Import Substitution	Political Economic Crisis	Boom	Recession	Recovery		Growth	
	1970	1973	1981	1982	1985	1986	1987	1988
GNP Growth Rate (%)	1.4	-5.6	5.5	-14.1	2.4	5.7	5.4	5.5
Inflation Rate (consumer prices-%)	33.0	353.6	19.7	9.9	30.7	19.5	21.5	12.0
Unemployment (%)	3.8	n.d.	12.1	21.6	11.9	8.8	7.9	7.5
Central Government Expenses (% GNP)	19.8	35.7	30.3	31.2	31.6	28.2	26.1	24.3
Fiscal Deficit (% GNP)	2.9	13.0	-2.6	1.0	2.4	1.9	.8	.8
Exports (billion dollars)	1.2	1.2	3.9	3.7	3.8	4.2	5.2	6.2
Trade Balance (billion dollars)	0.3	0	-2.7	-0.6	.9	1.1	1.2	1.6
Real Interest Rates for Short-Term Loans (%)	n.d.	n.d.	38.7	35.1	11.0	7.5	9.2	10.0

Chile has a population of about 12.7 million persons and a per capita GNP of $1,525.

DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

June 15, 1989

Dear Mr. Chairman:

I am pleased to respond to the questions which you submitted in connection with my March 16, 1989, testimony on the international debt strategy.

I appreciate your continuing interest and support on this important issue.

Sincerely,

David C. Mulford
Under Secretary
(International Affairs)

The Honorable Paul S. Sarbanes
Chairman
Subcommittee on International
  Finance and Monetary Policy
United States Senate
Washington, D.C. 20510

Enclosure

Senator Riegle: What types of regulatory incentives are being contemplated to get banks to participate in forgiving some portion of the debt? Will the plan work if some banks refuse to participate, yet still benefit from improvements in the ability of LDCs to service their debt? If we pursue a debt relief policy, how does the Treasury Department plan to deal with the "free rider" problem?

Dr. Mulford: The Finance Ministers of the Group of Seven (G-7) industrial countries agreed at their April 2nd meeting to review their tax, accounting, and regulatory structures with a view to reducing impediments to debt and debt service reduction, where they exist.

Banks can choose to participate in providing external financial support, including new lending, debt, and debt service reduction in many ways. In the past, "free riders" have failed to participate, in part because options which they might have chosen were not available. Several banks chose to sell their loans in the secondary market, even though this provided no direct or certain benefit to the debtor nations. A broader range of debt or debt service reduction options may attract these banks to participate in a manner that benefits individual debtor nations. We believe that many banks will choose to engage in debt or debt service transactions to obtain instruments with better assurance of payment, as well as to strengthen the values of their portfolios through improved credit profiles for the debtor countries. As a result of this broader range of options, there should be fewer free riders. While some banks may not participate in this process, we do not believe that this will significantly affect the strategy's effectiveness, unless very large banks with large exposures should decide to become "free riders".

Free riders have represented a small portion of total LDC commercial bank debt, and we believe that the cost of a government-orchestrated solution to the free-rider problem is disproportionate to the benefits of the solution. The legal requirements for a solution are somewhat Draconian and, therefore, not very desirable. On the other hand, it may be possible for individual debtors and their principal commercial creditors to design a means of addressing this problem, although the details of such an approach remain unclear. This is a problem that we will continue to monitor closely.

Senator Riegle: The new debt initiative reportedly contemplates average debt relief of 20% for 39 debtor countries. What is the basis for this figure? Does it represent debt reduction or debt service reduction? In view of rising interest rates, will it be sufficient to remove external debt as an obstacle to growth and development in these countries?

Dr. Mulford: Debt and debt service reduction will be worked out on a case-by-case basis for each individual debtor country through negotiations with its commercial banks. It is very difficult to calculate on a global basis for all debtors the potential debt and debt service reduction which could be accomplished. The exercise is imprecise owing to the many variables involved -- the number of countries, the prices of their debt, interest rate changes and the degree of interest write-downs by the banks, the discounts on individual transactions, and the magnitude of debt involved in debt and debt service reduction transactions, including debt/equity swaps. Such transactions, however, can provide positive external financial support for debtors' efforts to achieve stronger growth through needed reforms.

Senator Riegle: Fiscal responsibility requires that taxpayer liability be significantly increased only as part of a lasting solution to the debt crisis and not as part of a temporary fix or "band-aid." In this connection, are World Bank and other taxpayer-backed guarantees on unforgiven debt contemplated? If so, will such guarantees be made available on an ad hoc basis for any country, or only in the context of a coordinated package designed to restore the basic creditworthiness of a country which agrees to economic reforms?

Dr. Mulford: Debtor countries will have access to World Bank and IMF resources for debt and debt service reduction only if they have accepted an economic reform program with one or both of those institutions. Under the new approach, we expect the Fund and Bank to provide financial support for transactions which involve a significant reduction in principal or interest rates. We have proposed two mechanisms for such support: (1) a set aside of policy-based loans to facilitate debt reduction transactions; and (2) limited interest support for transactions involving significant debt or debt service reduction. The Fund and Bank are currently considering ways to implement both of these mechanisms. We have not suggested the use of any U.S. Government guarantees.

Senator Riegle: What criteria will be used to determine which countries will be eligible for debt relief? How and by whom will the quid pro quo of economic reforms be negotiated? What, if any role, will adherence to IMF conditions play in determining which countries will qualify for debt relief?

Dr. Mulford: Debtor countries with large external medium-term commercial bank debt and a clear need for debt reduction as a means of achieving medium-term financing and development objectives can seek to obtain IMF and World Bank financial support for debt or debt service reduction. These countries will need to negotiate an economic reform program with the IMF and a structural or sectoral adjustment program with the World Bank. Countries which have demonstrated performance in implementing needed reforms and which are actively seeking commercial bank support are likely to be the first candidates for this new approach.

Senator Riegle: Mexico currently transfers about $12 billion per year abroad in interest and principal. The new Salinas

Government is reportedly seeking to reduce this by as much as $7 billion. How large a decrease in Mexico's annual debt service bill does the Administration believe is necessary? Will a certain number be agreed upon in advance? If so, by whom and under what procedure?

Dr. Mulford: The extent of debt and debt service reduction in Mexico, as well as the amount and mechanisms for providing new money, will be worked out by the Mexican Government and its creditor banks. The Brady approach has increased the role of debt and debt service reduction under the international debt strategy, but I must emphasize that such reductions are voluntary and market-based. It is therefore not appropriate for the U.S. Government to set targets for debt service reduction.

Senator Riegle: World Bank President Barber Conable has highlighted the need to leverage, not trade off, resources available for development finance. In view of the World Bank's loan to capital restrictions, how will the new policy affect the Bank's future lending activity?

Dr. Mulford: Under the new approach, the World Bank will set aside a portion of its policy-based loans to facilitate transactions involving significant debt reduction. Such support would not be additional to current expected lending programs, but would redirect a portion of such loans to help reduce the debtor's stock of debt. In addition, the Bank will consider whether to provide limited interest support for transactions involving major reductions in principal or interest rates. This will be done in a way which will preserve the financial integrity of the Bank without adversely affecting the availability of resources for traditional operations.

Senator Graham: Small but critical countries like Jamaica -- which is saddled with the highest per capita debt in the Western Hemisphere -- would not be affected by the Brady Plan to any great extent. Only about 9 percent of its debt is commercial. Roughly 45 percent of its debt is official bilateral debt. Has the Administration prepared a program to deal with official U.S. debt for countries like Jamaica?

Dr. Mulford: Under the new debt approach creditor governments will continue to reschedule official credits in the Paris Club. The new debt approach will have implications for Paris Club procedures and processes which are still being considered. However, any decisions on changes in the Paris Club will need to be taken by the group as a whole, where decision-making is by consensus.

Senator Graham: Since the Jamaican commercial debt is so small, has the Treasury given any consideration to making Jamaica a "test case" for implementation of the Brady Plan? I would think that it would be much easier to start this program in a country where the total debt is relatively small in dollar terms rather than trying to implement it first in Brazil.

Dr. Mulford: The timing of a country's participation in the new approach is completely dependent on its negotiations with the IMF, World Bank, and commercial banks. We are not pushing any country as a test case, but rather advising all interested parties to tailor these new ideas to their individual cases and to move forward as rapidly as their situation warrants.

Senator Graham: What are any specific legislative initiatives you would request from Congress that you need to implement your revised Latin debt proposal?

Dr. Mulford: We are calling on the multilateral development banks to play a major role in this new approach to international debt. While continuing to promote economic reforms, the World Bank will also provide financial support for debt and debt service reduction. The operations of the regional development banks are complementary to the World Bank's policy-based lending and can help reinforce the incentives for debtor countries to implement policies that will lead to sustainable growth and recovery. Our legislative funding requests for these institutions represent essential U.S. support which can allow the multilateral development banks to assume a key role in the new approach to international debt.

Senator Graham: Would you consider focusing any of your first efforts in implementing the revised debt proposal on smaller countries near the U.S. like the Caribbean or Central American countries?

Dr. Mulford: While Treasury officials have met with a number of representatives from Caribbean and Central American countries, it is important to emphasize that the U.S. does not decide which countries will be the first to benefit from debt reduction. Costa Rica, however, may be an early candidate since it has recently negotiated IMF and World Bank programs and has been negotiating a possible buyback of commercial bank debt with the banks for sometime now.

Senator Dixon: The primary problem for debtor countries is the high net cash outflow they face for debt service payments. Debt reduction does not necessarily result in a significant decrease in debtor country total debt service payments. Does Treasury intend to focus primarily on reducing debt service payments, or will the focus be split equally between debt principal and debt service reductions?

Dr. Mulford: Relative amounts of debt and debt service reduction will depend on each country's individual situation and the negotiations between the debtor country and its creditor banks. The reduction of debt stock is important because it represents a permanent reduction of both external debt and debt service. Such reductions can be very important from a political perspective, and by improving the debtor's credit profile, may also help to restore investor confidence. Debt service reduction can also provide immediate cash flow relief. The cost to banks in this case is income foregone rather than a loss on principal. While equivalent percentage cuts in principal and interest rates provide equivalent debt service relief, the first provides permanent relief while the second may be negotiated for a temporary period only. We believe, therefore, that countries seeking debt service reduction should also engage in transactions which reduce their stock of debt.

Senator Dixon: Aside from increased parallel lending from Japan, what are Treasury's proposals for encouraging new lending to support economic growth? How can we encourage banks to provide new money while we are simultaneously asking them to write-down the principal of old loans?

Dr. Mulford: Our suggestions are intended to meet financing needs through a broad array of mechanisms, including:

- flight capital repatriation;
- new investment flows;
- debt and debt service reduction; and
- differentiated new money from commercial banks.

We feel that debt and debt service reduction can shrink financing needs to more realistic levels, while also improving a debtor country's credit profile. We believe banks would be willing to reduce debt and make new loans at the same time if debt reduction is voluntary and new lending is differentiated from old debt. Differentiated new money mechanisms could include new money bonds with convertible features, club loans, trade credits, or project loans.

Senator Dixon: How much parallel financing does Treasury expect Japan to provide? Will such parallel lending be tied to purchases of Japanese goods and services?

Dr. Mulford: Japan has indicated that it will make available $4.5 billion in parallel lending with IMF/World Bank programs if the proposed approach, including interest support, is implemented. Japan has also determined that these funds will not be tied to purchases of Japanese goods and services.

Senator Dixon: What are Treasury's specific proposals for reducing capital flight? Do any require domestic legislation for their implementation?

Dr. Mulford: We believe that developing countries must take the lead in repatriating flight capital. One way to encourage and help these countries to address this problem is to place greater emphasis on flight capital in IMF and World Bank programs. Under a Fund adjustment program, for example, the IMF could regularly review a country's progress on flight capital repatriation. Also, the Bank and the IFC could focus more on financial sector reforms. This could involve measures to improve the investment climate, to liberalize the banking sector, and to develop domestic financial markets in debtor nations. Debt/equity swap programs which permit nationals to engage in such swaps can also provide a vehicle for flight capital repatriation. We do not anticipate any need for U.S. domestic legislation to address the flight capital problem.

Senator Dixon: As part of the proposed expanded role for the World Bank, is the U.S. Government willing to allow the World Bank or an affiliate of the World Bank to establish insurance programs or similar facilities to encourage debt reduction (for example, allowing commercial banks to buy insurance coverage from the World Bank for interest payments to be made on collateralized debt instruments)?

Dr. Mulford: A World Bank task force is currently considering the establishment of limited interest support for transactions involving debt service reduction. In developing its proposals, the task force must seek to preserve the financial integrity of the World Bank. With this in mind, we have emphasized the need for limited support for debt service reduction. The Bank, for example, might provide interest payment support for one year on a rolling basis. We would not favor long-term, broad insurance programs that might threaten the Bank's financial status.

Senator Dixon: Is Treasury aware of any reason why Financial Accounting Standard 15 (FASB 15) would not apply to a negotiated reduction of interest rates? Has Treasury, the Federal Reserve Board, the SEC, or any other governmental agency discouraged the use of FASB 15? Would Treasury be willing to clarify the application of FASB 15 as it was clarified in 1986 in connection with certain agricultural loans?

Dr. Mulford: Many of the issues you have raised fall under the jurisdiction of the regulatory agencies. I can speak only for Treasury. Treasury has discussed the issue of FAS 15 with the regulators. We have been assured that FAS 15 is and has been available as an accounting vehicle for loan restructurings. While banks have not used FAS 15 on a broad basis in the LDC context, Brazilian exit bonds negotiated as part of the recent Brazilian financing package have been considered to meet the FAS 15 requirements. With the new emphasis on debt and debt service reduction, some banks may make greater use of it in the future.

Senator Dixon: Is the U.S. Government considering granting debt relief through interest rate reductions in the context of Paris Club negotiations? If so, is such relief being considered for all debtor countries or only the very poorest ones?

Dr. Mulford: In the context of the Toronto Summit consensus, some creditor governments have been charging below cost of funds interest rates on export credit debt rescheduled in the Paris Club for the very poorest countries. For our part, legal and budgetary problems have precluded interest rate relief of this kind; instead we have been providing comparable relief by extending rescheduling, grace and repayment periods. The more generous Toronto Summit terms are limited to the very poorest countries only, however.

Senator Dixon: In most reschedulings since 1982, the IMF, World Bank, commercial banks, and bilateral creditors have provided funds for debt relief through a system of "cross-conditionality", whereby no one group of creditors is willing to proceed without participation by all creditors. Is the U.S. Government now willing to approve IMF and World Bank programs and to provide bilateral debt relief to countries which have undertaken necessary reforms but do not have commitments from all groups of creditors?

Dr. Mulford: The new approach to strengthen the international debt strategy emphasizes that the IMF and World Bank will continue to play central roles in the strategy, by assisting developing countries in formulating sound macroeconomic and structural policies, and by helping to catalyze financial support from other creditors.

The IMF and World Bank will also be reviewing their policies regarding the timing of policy-based loan disbursements. We need greater flexibility to allow the launching of debtors' economic-reform programs with meaningful support from creditors at the outset, not months later. This is why we have recommended that the Fund and Bank allow disbursements to occur once a waiver agreement has been reached, but prior to agreement on a full commercial bank financing package (as was previously required).

As to questions regarding bilateral debt relief, it is important to note that the U.S. reschedules official credits in a multilateral context, the Paris Club, and is therefore bound by the rules and procedures governing this group's operations. A longstanding condition of relief through Paris Club reschedulings is an approved IMF program. Given that the IMF may move forward with disbursements in some cases without commercial bank financing and other financing assurances, Paris Club creditors will need to consider the implications of this change and determine how it will effect their operations.

Senator Dixon: Would the Treasury support clarifying the rules concerning the creation of Allocated Transfer Risk Reserves (ATRRs) under the International Lending Supervision Act to make clear that the negotiation of a reduced interest rate would not adversely affect a country's rating?

Dr. Mulford: Existing legislation regarding the ATRR provides all the flexibility needed to accomplish this goal. We see no need, at this time, to modify the legislation.

Senator Dixon: Many debtor countries have tried to tie debt service payments to alternative measures of their economic performance (for example, GDP or key exports). Is Treasury considering accepting U.S. bilateral debt payments based on such mutually agreed formulas, in order to encourage debt service reduction? If such formulas are not acceptable, is Treasury considering other forms of debt service reductions? Would Treasury support such formulas or other reductions with respect to commercial bank debt?

Dr. Mulford: Restructuring of repayments on U.S. official debt occurs through Paris Club reschedulings, which include all official creditors. The terms and conditions of reschedulings are determined by these creditors and the Paris Club has traditionally attempted to adjust the terms of rescheduling in light of the debtor country's payments capacity. However, the group has, in this regard, avoided rigid formulas or rules, preferring to operate on a case-by-case basis. The new debt approach, however, does have implications for the Paris Club. Any decisions on changes in Paris Club procedures will be taken by the group as a whole, where decision-making is by consensus.

In terms of commercial bank debt, we would have no objections to debtors and creditors negotiating debt reduction methods that were tied to alternative measures of economic performance, if they wish to do so.

DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

June 16, 1989

Dear Mr. Chairman:

I am pleased to respond to the questions which you submitted in connection with my March 16, 1989, testimony on the international debt strategy.

I appreciate your continuing interest in this important issue.

Sincerely,

David C. Mulford
Under Secretary
(International Affairs)

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Enclosure

Senator Garn: The Treasury plan leaves the mechanics of debt reduction agreements to debtor governments and their creditors, yet these deals will require the cooperation of international institutions being asked to take on new missions, commercial banks with varied tax, accounting and regulatory policies regarding LDC debt. With these varied interests at work, won't the Bank, Fund, and G-7 governments influence, if not set, the terms and conditions of these deals? Won't the Bank and Fund have to say how much debt relief is enough before putting up money to fund the deals?

Dr. Mulford: The answer is no to both questions. The type of debt and debt service reduction will depend upon negotiations between the debtors and commercial banks. Neither the IMF nor the World Bank will be directly involved in these negotiations. The amount of debt relief will be determined by the markets, not by the international financial institutions.

Senator Garn: The missions and financial condition of the Bank and Fund will be directly altered by the Treasury program. Bank and Fund financing of debt reduction programs will displace other developmental and balance-of-payments assistance that they normally provide, a major concern of the Europeans, and for major debt reduction to occur the claim on these institutions could be very large. How large a claim on Bank and Fund resources do you anticipate the Treasury proposal would make? Won't the plan fundamentally shift the mission of Bank and Fund away from development assistance and standard balance-of-payments aid? Is this shift acceptable to the institutions and other governments?

Dr. Mulford: The Fund and the Bank will set aside a portion of their policy-based loans to facilitate debt reduction transactions. The Governors of these institutions have also asked them to examine the establishment of limited interest support for transactions involving debt service reduction. The exact amount of resources involved will depend upon ongoing negotiations with these institutions.

The mission and financial condition of the Fund and Bank will not be altered by the new debt approach. The monetary character of the Fund will not change and the World Bank will continue to provide technical assistance and lending in support of development.

Recent communiques issued by the G-7 countries, the Interim Committee, and the Development Committee have included broad international support for the strengthened debt strategy. World Bank President Conable and IMF Managing Director Camdessus have both endorsed the new approach.

Senator Garn: Channeling this program through the Bank and Fund insulates the U.S. budget from an immediate claim but creates a deferred claim in terms of earlier replenishment of Bank funds, a quota increase, or calls on MDB callable capital if the LDCs do not perform. Secretary Brady's speech noted that adoption of the plan would set the stage for a quota increase later this year. By how much would this plan advance the date of a next

World Bank capital increase? Can we expect a request for funds for an IMF quota increase later this year? Does conditioning a quota increase on expanded IMF lending for LDC debt relief alter the nature of U.S. contributions to the Fund from a U.S. deposit into its own account to straightforward development assistance?

Dr. Mulford: A World Bank capital increase of $74.8 billion was approved in March 1988. We do not expect that the new debt approach will materially advance the date of a future World Bank capital increase. Nor do we expect the new debt approach to result in calls on callable capital. In fact, we expect that Fund and Bank exposure will be significantly lower under the new approach than under a continuation of the current strategy.

As Secretary Brady indicated in his speech, implementation of U.S. proposals to strengthen the debt strategy could help lay the basis for an increase in IMF quotas. However, there are other important issues that must also be addressed in the quota reviews including the development of a clear vision of the IMF's role in the 1990's, the development of significant progress in dealing with the problem of IMF arrears, and the size and distribution of a quota increase. At its recent meeting, the Interim Committee urged the IMF Executive Board to complete its work on the quota review with a view to a decision by the Board of Governors before the end of the year. The IMF presently has adequate resources to meet its responsibilities, including at least the initial requirements under its expanded role in a strengthened debt strategy, and no funds for a U.S. quota increase are expected to be required in the current fiscal year (FY 1989) or in the next fiscal year (FY 1990).

The IMF support for debt and debt service reduction will not alter the monetary character of the IMF, the nature of U.S. transactions with the IMF, or the budgetary treatment for U.S. participation in the IMF.

The IMF's support for debt reduction will be in the form of a set-aside of a portion of the loans provided under regular IMF adjustment programs. The details of the arrangements for interest support are still being examined but are also expected to take the form of loans. Such loans will be conditioned on the borrower adopting an IMF approved economic program and will carry the same interest rate and maturity provisions as other IMF loans. Consequently, there will be no change in the IMF's relationship with the borrower.

Moreover, the use of the United States or other members' quota subscriptions to finance the IMF loan to the debtor nations will continue to result in a liquid claim on the IMF which is treated as an international reserve asset by the United States and other creditors. This reserve asset will earn a market-based interest rate and is available automatically to meet a balance of payments financing need. Consequently, any transfer of dollars from the

United States to the IMF will result in an equal, offsetting receipt of a reserve asset and no net budget outlays.

Senator Garn: Commercial banks are called upon to waive loan covenants that protect the value of their current loans, which requires near or total unanimity. Even if this is achieved, voluntary programs are prone to "free riders" that sit back and collect their full debt service. How aggressively will or should G-7 governments involve themselves in order to persuade a large number of banks to participate or to ensure that "acceptable" deals are struck? If major banks choose not to participate, would Treasury find acceptable an outcome in which smaller banks write down their debts to near secondary market prices while major LDC lenders hold their debt to maturity at full value?

Dr. Mulford: We believe the market has responded favorably to Secretary Brady's new emphasis. Indeed, in a March 16, 1989, report, Salomon Brothers states that "if the Mexican debt plan unfolds as we believe likely, bank stock investors will positively embrace this development by dramatically revaluing prices of money center bank stocks." Bank stock prices have risen since Secretary Brady announced the new emphasis on debt reduction. With such a favorable market response, we expect the free rider issue to be manageable.

Although the United States and other creditor governments have undertaken leadership roles in the international debt strategy, their involvement in the process of negotiating solutions to individual countries' commercial bank debt problems must remain limited. As leading members of the international financial institutions, G-7 governments have a key voice in how debtor countries' needs and problems are assessed. Creditor governments can also work through these institutions to influence the amount and type of support provided for individual countries. However, it is important that neither the international financial institutions nor individual creditor governments position themselves between debtor countries and their commercial banks. Nevertheless, we will monitor developments closely and encourage all parties to reach timely conclusions to negotiations.

As a result of the broader range of options now available to banks for providing countries with financial support, there should be fewer free riders. While some banks may not participate in this process, we do not believe that this will significantly affect the strategy's effectiveness, unless very large banks with large exposures should decide to become "free riders".

Free riders have represented a small portion of total LDC commercial bank debt, and we believe that the cost of a government-orchestrated solution to the free-rider problem is disproportionate to the benefits of the solution. The legal requirements for a solution are somewhat Draconian and, therefore, not very desirable. On the other hand, it may be possible for individual debtors and their principal commercial creditors to design a means of addressing this problem, although the details of such an approach remain unclear. This is a problem that we will continue to monitor closely.

UNITED STATES DEPARTMENT OF COMMERCE
The Assistant Secretary for Administration
Washington, D.C. 20230

JUN 6 1989

Honorable Donald W. Riegle
Chairman, Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

In accordance with the provisions of the Federal Advisory Committee Act, I am submitting a copy of the charter for the U.S. Automotive Parts Advisory Committee.

Sincerely,

Thomas J. Collamore
Assistant Secretary
for Administration

Enclosure

Attachment A

U.S. DEPARTMENT OF COMMERCE
CHARTER OF THE
U.S. AUTOMOTIVE PARTS ADVISORY COMMITTEE

Establishment:

The Secretary of Commerce, as directed by the Fair Trade in Auto Parts Act of 1988, hereby establishes the U.S. Automotive Parts Advisory Committee (the "Committee") pursuant to the Federal Advisory Committee Act, 5 U.S.C. App. 2.

Objectives and Duties

1. The Committee advises Department officials on the establishment of an initiative to increase sales of U.S.-made auto parts to Japanese markets.

2. The Committee draws on the expertise of its members and other sources to provide advice and make recommendations to Department officials on all issues related to sales of U.S.-made auto parts to Japanese markets. In this role, the Committee: 1) reports annually to the Secretary of Commerce on barriers to sales of U.S.-made auto parts and accessories in Japanese markets; 2) assists the Secretary in reporting, or, at the request of the Secretary, reports to the Congress, on the progress of sales of U.S.-made auto parts in Japanese markets, including the formation of long-term relationships; 3) reviews and considers data collected on sales of U.S.-made auto parts to Japanese markets; 4) advises the Secretary during consultations with the Government of Japan on these issues; and 5) assists in establishing priorities for the initiative to increase U.S.-made auto parts sales to Japanese markets, and otherwise provide assistance and direction to the Secretary in carrying out the initiative.

3. The Committee functions solely as an advisory body in accordance with the provisions of the Federal Advisory Committee Act.

Members and Chairman:

1. The Committee consists of no more than 50 members. Members are appointed by the Secretary of Commerce to assure balanced representation of the auto parts industry, including small and large businesses, and trade associations. Other groups having interest in trade in auto parts also will be represented on the committee. Members are appointed for two years, and serve at the discretion of the Secretary. Vacancy appointments are for the remainder of the unexpired term of the vacancy.

2. The Committee Chairperson will be selected by the Committee from its members.

3. The Deputy Assistant Secretary for Automotive Affairs and Consumer Goods or his/her designee will serve as the Designated Federal Official (DFO) to the Committee.

Administrative Provisions

1. The Committee reports to the Secretary of Commerce through the Deputy Assistant Secretary for Automotive Affairs and Consumer Goods.

2. The Committee generally meets semi-annually. However, additional meetings may be called at the discretion of the Chairperson.

3. The Office of Automotive Industry Affairs in the International Trade Administration provides support services to the Committee.

4. Members of the Committee are not compensated for their services or their travel expenses.

5. The estimated annual operating cost of the Committee is $10,000 which includes one-quarter person-year of staff support.

6. The Committee may establish such subcommittees or work groups from among its members as may be necessary, subject to the provisions of the Federal Advisory Committee Act and the Department of Commerce Committee Management Handbook.

7. All members of the committee will have appropriate security clearances as classified information may be provided to the Committee.

Duration

The Committee will terminate two years from the date of this charter unless earlier terminated or renewed by proper authority and appropriate action.

JUN 6 1989
Date

Assistant Secretary for Administration

UNITED STATES DEPARTMENT OF COMMERCE
The Assistant Secretary for Administration
Washington, D.C. 20230

JUN 18 1990

Honorable Donald W. Riegle
Chairman, Committee on Banking, Housing
  and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

In accordance with the provisions of the Federal Advisory Committee Act, I am submitting a copy of the charter amendment for the Caribbean Basin Business Promotion Council.

Sincerely,

Thomas J. Collamore
Assistant Secretary
  for Administration

Enclosure

Attachment B

U. S. DEPARTMENT OF COMMERCE

AMENDMENT TO THE CHARTER OF THE CARIBBEAN BASIN BUSINESS PROMOTION COUNCIL

Administrative Provisions are revised to read:

4. Members of the Council are not compensated for their services or their travel in conjunction with attending Council meetings. Private sector members of the Council shall be reimbursed for only their expenses in conjunction with overseas missions or marketing programs authorized by the Caribbean Basin Information Center and subject to the funding level and limitations specified in the Participating Agency Service Agreement with the U.S. Agency for International Development.

Assistant Secretary for Administration

JUN 18 1985
Date